A macro view of the fiscal health of States

Published On: 05-07-2023

Why in News: In India, the States mobilise altogether 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

Fiscal imbalance and consolidation

As we complete the first quarter of the fiscal year 2023-24, it is becoming evident that the increase in general government deficit and debt that occurred during the COVID-19 pandemic has begun to recede.

There have been significant post-pandemic fiscal corrections at the Union and State levels.

At the Union level, the fiscal deficit declined from 9.1% of GDP in 2020-21 to 5.9% in 2023-24 (BE).

All State fiscal deficit was 4.1% of GDP in 2020-21. It declined to 3.24% of GDP in 2022-23 (RE). For the major States, for the year 2023-24 (BE), it is expected to be 2.9% of GDP

This sharp reduction in fiscal deficit suggests that we cannot have an impressionistic view of the fiscal situation of the country, especially on the finances of States.

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 become available only after the publication of the Reserve Bank of India's (RBI) Annual Study on State Finances.

Aggregating fiscal data from individual State Budgets is rigorous and time consuming. Hence, the timeline of this publication by the RBI is during the second half of the fiscal year

The analysis here is based on the data collated from the individual Budgets of 17 major States. These States are responsible for more than 90% of the combined spending of all States.

Thus, fiscal issues emerging out of their Budgets are representative of the State finances in India. The analysis shows that these States together have managed to contain their fiscal deficits.

Significance of Fiscal Consolidation

This fiscal consolidation is significant in many ways.

First, States in aggregate managed to be fiscally prudent despite a significant contraction in revenues even during the peak of COVID-19.

Second, emergency provision for health spending and livelihood during the COVID-19 pandemic was not easy and required Union-State fiscal coordination.

Third, States were able to reprioritise expenditure and quickly contain the fiscal deficit.

Fourth, the reduction in fiscal deficit is a combination of expenditure-side adjustments, improved Goods and Services Tax (GST) collection and higher tax devolution due to buoyant central revenues.

Fifth, non-GST revenues are also showing signs of recovery after the pandemic in most States.

Fiscal challenges

There are significant fiscal challenges that need correction in the short to medium time frame — the most critical being containing the revenue deficit of States.

The reduction in fiscal deficit has not been accompanied by a corresponding reduction in revenue deficit. As in 2023-24 (BE), out of 17 major States, 13 States have deficit in the revenue account.

Out of 13 States, fiscal deficits in seven States are primarily driven by revenue deficits; the States being Andhra Pradesh, Haryana, Kerala, Punjab, Rajasthan, Tamil Nadu, and West Bengal. They also have large debt to GSDP ratios.

It is true that the mere presence of a revenue deficit cannot be considered as a sign of fiscal profligacy. It is also true that pressure on revenue expenditure was high during the COVID-19 pandemic.

A more detailed and careful analysis of the rise in revenue deficit of States is also necessary. However, increasing revenue deficit driving the fiscal imbalance has long-run fiscal implications and there is a need to correct this imbalance in the revenue account.

For these seven States, their specific shares of revenue deficit in fiscal deficit for 2023-24 are: Andhra Pradesh (40.9%), Haryana (50.9%), Kerala (60.4%), Punjab (70.7%), Rajasthan (39.7%), Tamil Nadu (40.8%), and West Bengal (47%). The all-State share of revenue deficit in fiscal deficit for the same year is expected to be 27%.

An assessment of successive Finance Commissions since the Twelfth Finance Commission identified three States, i.e., Kerala, Punjab and West Bengal, as fiscally stressed States. The number of States that are now fiscally stressed has increased to seven (measured in terms of the level of revenue deficit).

A sense of this can be made when the following fiscal numbers are considered: the combined fiscal deficit of these States is 3.71% of GSDP when the all-State average for the same is 2.9%; their combined revenue deficit is 2.15 % of GSDP, when the all-State revenue deficit is 0.78%; their combined debt ratio is higher than the Finance Commission recommended debt ratio for all States for the year 2023-24.

These States together contribute around 40% to India’s GDP. In this context, to ensure higher State-specific growth, the fiscal stability of State finances is critical.

Some of these States have also been big drivers of public capital expenditures and favoured investment destinations of private investors.

On the question of revenue deficit, a long-run view is also necessary. If we examine data from the last 20 years, revenue deficit had almost disappeared from State Budgets before COVID-19.

States, in aggregate, were generating revenue surpluses almost all the years during this period.

However, the re-emergence of revenue deficit in recent years should take the focus back on the management of revenue deficit by creating an incentive compatible framework. The following measures can be considered.

The Way Ahead

Going forward, interest-free loans to the States by the Union Government, if continued, may be linked to a reduction in revenue deficit.

This will help eliminate the possibility of a substitution of States' own capital spending and also prevent the diversion of borrowed resources to finance revenue expenditure.

A defined time path for revenue deficit reduction with a credible fiscal adjustment plan would help restore fiscal balance and improve quality of expenditure.

A forward-looking performance incentive grants could also be considered for a reduction of revenue deficit. In this context, different approaches provided by earlier Finance Commissions can be considered to decide the framework of the incentive structure.

In conclusion, we need to get the focus back on the management of revenue deficit. For this, a macro view is essential.