THE HINDU BusinessLine

The slow decline of State finances

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Profile of States' finances (in %)

Revenue deficit masked by rising grants

	States' own revenue/ RR	Shareable taxes / RR	Grants-in Aid / RR	Revenue deficit/ GDP	Fiscal deficit*/ GDP	Debt / GDP	Direct agri credit/ GDP
2007-08	58.3	24.3	17.4	-0.9	1.5	26.6	6.0
2008-09	58.1	23.2	18.7	-0.2	2.4	26.1	6.4
2009-10	58.9	21.5	19.7	0.5	2.9	25.5	6.5
2010-11	59.1	23.5	17.5	0.0	2.1	23.8	6.3
2011-12	59.8	23.3	17.0	-0.3	1.9	22.8	6.7
2012-13	61.6	23.3	15.1	-0.2	2.0	22.2	7.3
2013-14	61.7	23.2	15.0	0.1	2.2	22.0	6.6
2014-15	58.0	21.2	20.8	0.4	2.6	21.7	7.6
2015-16 (RE)	53.9	26.4	19.8	0.2	3.6	23.2	8.1
2016-17 (BE)	53.6	25.7	20.7	-0.1	3.0	23.9	NA

Source: RBI State Finances: A Study of Budgets, http://niti.gov.in/state-statistics & author's calculations
Revenue deficit = Revenue receipts less revenue expenditure
Gross fiscal deficit = Aggregate disbursements (net of debt repayments) less revenue receipts, non-debt capital receipts and recovery of loans & advances
*including UDAY

Revenue deficit numbers are window-dressed. Loan waivers and a general lack of fiscal correctness have worsened matters

The economy is facing serious challenges, including GDP growth slowing down to 5.7 per cent in the first quarter of 2017-18 from 7.9 per cent in the same quarter a year ago, and 'jobless growth'. Former Prime Minister Manmohan Singh's prognosis that demonetisation would shave 2 per cent off the GDP growth rate was prescient. Wholesale price inflation hit a four-month high of 3.24 per cent in August 2017 and was significantly higher than the 1.88 per cent in July 2017.

India's consolidated fiscal deficit ranges from 6.5 per cent to 7.0 per cent, while general government debt to GDP is approximately 70 per cent. Analysing the States' finances is useful in determining whether their performance is in tandem or at cross purposes with India's macroeconomic goals of reducing fiscal deficit and debt levels, while simultaneously accelerating GDP growth.

The pseudo revenue surplus

A cursory view of the States' combined finances indicate that revenue receipts (RR) grew by an impressive 2.6x to ₹226 billion during the 10-year period ended FY17 and that the States' consolidated revenue account was more or less balanced.

A closer examination reveals that there has been a significant change in the composition of RR. States' own revenues, comprising own tax and non-tax revenues, as a percentage of RR has declined to 54 per cent in 2016-17 from a 10-year high of 62 per cent in 2013-14. Grants-in-aid have steeply increased from 15 per cent of RR in 2013-14 to 21 per cent in 2016-17. The proportion of shareable taxes from the Central government has remained more or less stable at around 25 per cent.

The implication is that in the absence of grants in-aid, the States would be reporting a revenue deficit, that is, the States' operating revenues are inadequate to meet the operating expenses.

UDAY's role

The Centre requiring States to assume, during 2015-16 and 2016-17, 75 per cent of the ₹4 trillion debt of the financially distressed State-owned discoms under the Ujwal Discom Assurance Yojana (UDAY) increased the States' GFD.

Eight States borrowed ₹989.6 billion under UDAY during 2015-16. UDAY resulted in the annual growth of debt accelerating to 17.4 per cent in 2015-16 and 13.5 per cent in 2016 from 9.4 per cent in 2014-15.

Market borrowings finance 85 per cent of States' GFD. The high reliance on market borrowings threatens the sustainability of State finances as higher borrowings raise yields and the cost of debt. The low, albeit rising, ratio of capital outlay to GDP is yet another adverse consequence of market borrowings financing GFD. The declining trend in GFD excluding UDAY as a percentage of GDP, is no consolation.

The Fourteenth Finance Commission (FFC) recommended that the fiscal deficit of all States be anchored to an annual limit of 3 per cent of GSDP for the award period (2015-16 to 2019-20). States with a zero revenue deficit, a contentious issue, and debt to GSDP of less than 25 per cent and interest payments to RR of less than 10 per cent may clock a fiscal deficit of up to 3.5 per cent! In other words, the FFC sanctions States with a modicum of fiscal responsibility to adopt lax practices.

States welcomed the recommendations with gusto. Excluding Telangana, the annual liability growth of five non-special category States, none of whom had issued UDAY debt, accelerated in 2015-16 and 2016-17. The five States are Odisha, Madhya Pradesh, Tamil Nadu, Maharashtra and Gujarat.

Thus far, Uttar Pradesh, Punjab and Maharashtra have announced farm loan waivers of ₹770 billion, equivalent to 0.5 per cent of India's 2016-17 GDP at market prices. State elections are to be held in six other States from now to April 2019, when the general election will also be held. In 2015-16, direct agricultural credit was ₹110 trillion or 8.1 per cent of GDP. As stated in the RBI's August 2017 Monetary Policy statement, farm loan waivers will result in fiscal slippages, undermine the quality of public spending, and exercise inflationary pressures.

Improving liquidity

The liquidity position of several States has been improving as is evident from the rising trend in States' intermediate treasury bills and auction treasury bills balances. But the States availed themselves of a higher quantum of ways and means advances (WMA) and overdrafts (ODs) in 2016-17 than in the previous two years. Peak approximate WMA and OD utilisation was ₹38 billion in 2016-17 vis-à-vis ₹30 billion in 2015-16 and ₹25 billion in 2014-15.

According to the RBI's *State Finances: A Study of Budgets 2016-17*, "The consolidated finances of States has deteriorated in recent years, with the GFD-GDP ratio averaging around 2.5 per cent in the last five years (2011-12 to 2015-16) as compared with 2.1 per cent during the previous quinquennium ..... The GFD-GDP ratio in 2015-16 (RE) breached the 3 per cent ceiling of fiscal prudence for the first time since 2004-05."

It is, therefore, paradoxical that the RBI should project the GFD-GDP ratio to improve to 2.6 per cent in 2017-18 from 3.4 per cent in 2016-17. How is this possible if the recommendations of States' own 2017-18 pay commissions were to mirror those of the Central Pay Commission, the probability of farm loan waivers escalating, and the revenue uncertainty arising from GST implementation? The prevailing uncertainty about the revenue outcome from GST implementation will be offset by the Centre's compensation for any loss of revenue for the initial five years.

It is evident that States have had a significant role in pushing the economy into the quagmire it is in today. States attaining fiscal responsibility in India has essentially been a top-down exercise. The election manifestos of the five largest political parties in the Lok Sabha — BJP, INC, AIADMK, AITC and BJD — indicate that with the exception of the INC that committed to capping the fiscal deficit at 3 per cent, none of the other parties committed to definitive deficit targets.

State governments must pledge to strengthen their finances. Political parties disclosing State-specific and Union specific economic targets in their election manifestos, holding televised and online debates on economic policy as part of campaigning, and incumbent governments reporting actual performance versus election commitments must be made mandatory.

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(This article was published on September 26, 2017)