HOW INDIA'S STATES ARE SINKING POST PANDEMIC

Recent state budgets show the immediate fallout of 2020. The ripple effects will badly impact citizen services.

Maharashtra, one of the worst-affected states by the coronavirus, spent 24% less than budgeted on health in 2020-21. REUTERS

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Financial year 2020-21 was catastrophic for the finances of most Indian states, which were in any case already reeling from an economic downturn over the past few years. The pandemic decimated collections from conventional revenue sources, while stretching the states' expenditure on healthcare. This, coupled with a significant delay on the Centre's part in disbursing states their share of taxes, has pushed many of them to the brink.

Against this backdrop, the recent budgets presented by state governments for the forthcoming fiscal year is a response to the carnage of the past year; they also chart a new course toward financial stability and recovery. The economic and fiscal challenges for states are many, and some predate the pandemic.

A quick reading of the budgets, which have received little attention, present a recurring theme: collapse in state revenues and, consequently, a reduction in capital expenditure. Giving secondary status to capital expenditure—which constitutes good spending, as it creates future growth possibilities—is something that the states were doing even before the pandemic. Part of this flowed from two decisions that they signed up for: to keep their borrowings with certain limits and a nationwide indirect tax system.

Both these decisions shrunk their fiscal autonomy. Even before covid, there was a certain tension in how states adapted to these two changes. Due to the pandemic, much has gone awry on both fronts—leaving the states to reconcile their current fiscal needs with decisions of the past and future changes that are imminent.

COVID IMPACT

The predicament that the states find themselves in flows from revenues. Most states have realized lower revenues than they budgeted for in 2020-21, according to data compiled by PRS Legislative Research, a research institute. The highest shortfall is seen in Delhi (34%) and Kerala (33%). In most cases, the decline is 10-15%. Yet, almost all states have budgeted higher expenditure in 2021-22 as compared to their pre-covid estimate for the year.

But there's a price to pay. This is reflected in their fiscal deficit, which is the extent of current spending a state is financing via debt, shows an analysis of 13 state budgets for 2021-22 by State Bank of India (SBI) research. The average fiscal deficit for these 13 states has increased to 4.5% for 2020-21 (revised estimates) from 2.6% in 2019-20. This increase is particularly high for poorer states such as Bihar and Uttar Pradesh.

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Collectively, capital expenditure across these 13 states was 11.3% lower than the budgeted amount in 2020-21. While this sharp retrenchment in expenditure is an immediate consequence of the pandemic, a combination of factors has contributed to a secular decline.

FRBM AND AUSTERITY

Under the Fiscal Responsibility and Budget Management (FRBM) Act, passed in 2003, states are mandated to keep their fiscal deficit within 3% of their gross state domestic product (GSDP). As a consequence, the fiscal deficit of the states has steadily declined since 2003-04.

However, they spiked between 2015 and 2017 due to the implementation of a scheme to restructure the finances of electricity distribution companies, most of which were loss-making, and debt saddled. This scheme allowed state governments to take over 75% of the debt of the discoms as of 30 September 2015 and pay back lenders via bonds. Following this shock, there was significant consolidation on the deficit front in subsequent years.

The consolidation in the years prior to the pandemic, however, came at a cost. A September 2019 report by Reserve Bank of India (RBI) on state finances notes that fiscal austerity has been achieved by sharp retrenchment in capital expenditure *(see Chart 1)*. This has potentially adverse implications for economic development.

During the current fiscal, while several states have overshot the 3% limit, the financial austerity mandated by the FRBM Act will pressure states to rein in expenditure in the coming years *(see Chart 3)*. According to SBI research, nine of the 13 states reported lower capital expenditure in 2020-21, as compared to budgeted amounts. Gujarat (28.3%) and West Bengal (27.4%) showed the biggest falls. Among the four that bucked this trend, Bihar, Madhya Pradesh and Uttarakhand registered marginal increases, and Rajasthan stood out with an increase of 46%.

Considering that states incur the larger share of developmental expenditure, the shrinking of essential public expenditure will be detrimental to the welfare of most citizens. The states' aggregate development expenditure—which comprises key expenditure on social and economic services such as healthcare, housing, social security and agriculture—rose steadily as a percentage of total expenditure between 2003-04 and 2008-09. Since then, though, it has remained mostly constant, at 64% of total expenditure.

The pandemic has laid bare the inadequate healthcare and social infrastructure of the states and emphasized the need for structural changes to improve accessibility to healthcare and other essential social services. The SBI report, however, notes that only five of the 13 states analysed increased allocations to health and family welfare by above 20% for 2021-22.

In fact, even as they battled the pandemic, six of these states spent less on health and family welfare in 2020-21 than their budgeted amounts, announced prior to the pandemic. Maharashtra, one of the worst-affected states by the coronavirus, spent 24% less than budgeted on health in 2020-21. This is likely a consequence of the revenue shock due to the pandemic.

TENUOUS CENTRE-STATE TIES

One of the most contentious issues regarding state finances is their relationship with the Centre. The structure of the federal system of governance in India is predicated on a fine balance between revenue-raising capability and administrative responsibility at various levels.

However, as the RBI report on state finances notes, the Centre mobilizes higher taxes while states are invested with greater responsibilities. To redress this imbalance, there exist constitutional mechanisms in the form of tax devolution, Finance Commission (FC) grants, loans from the Centre and centrally sponsored schemes (CSS).

The implementation of the goods and services tax (GST) in 2017 added a new variable in the Centre-state dynamic. GST subsumed many taxes which were previously under the control of state governments. To assuage states, the Centre assured them an annual 14% increase in state GST revenues for the first five years, till 2022. However, these payments have often been delayed and erratic, leading to disaffection among states.

The devolution of central taxes and grants to states is based on the recommendations of the Finance Commission. Central transfers to states declined during the 1990s but increased thereafter to constitute close to 46% of states' revenues during 2015-20 *(see Chart 2)*.

The states' share in the divisible pool of central taxes has also seen a rise in successive Finance Commission rounds: from 29.5% of all central taxes in the 11th FC regime (2000-05) to 42% in the 14th FC regime (2015-20). However, this subsumed some Plan grants in the tax devolution and discontinued sector-specific grants. The 15th FC report (2021-25) has maintained that level.

To help states tide over the revenue losses ensuing from the pandemic, the 15th FC has recommended revenue deficit grants to the tune of about ₹3 trillion over the five-year period ending 2025-26. This is for the states that cannot meet their fiscal needs even after tax devolution. However, these grants are front-loaded, with about 70% of payments disbursed in the first two years. The states' finances will also take a hit after payment of the GST compensation cess by the Centre is stopped in June 2022.

Another means for the state governments to fund their expenditure is through external borrowings. However, the FRBM Act restricts borrowing to 3% of GSDP. The 15th FC has allowed states to borrow an additional 2% of their GSDP from the open market, but this is contingent on them undertaking various reforms, especially in the power sector.

State governments have long argued that austerity conditions imposed by the FRBM Act are extremely restrictive and need to be reframed. The 15th FC report recognizes that the FRBM Act needs major restructuring, especially post the pandemic, and recommends that a new framework is needed to achieve debt sustainability. To this end, a high-powered inter-governmental group is to be set up to craft the new FRBM framework and oversee its implementation.

WAY FORWARD

States have a central role to play in the ensuing economic recovery post the pandemic. However, besides the economic impact of covid-19, states are contending with shrinking revenue autonomy and a low tax buoyancy (taxes are rising at a lower proportion than an equivalent growth in GDP).

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Further, there is greater uncertainty associated with grants and transfers from the government. Hence, states will have to make sustained efforts towards mobilizing more revenues. The RBI report on state finances recommends that states should focus on maximizing efficiency gains rather than increasing tax rates.

States can harness the GST architecture better to achieve tax revenue growth targets, thereby, gradually reducing their dependence on the compensation cess. The RBI report also recommends expanding the tax base by reducing the cost of tax compliance.

Further, states will have to move towards break-even pricing for utilities such as power and irrigation, and rationalize subsidies associated with them. There is also a need to front-load essential capital expenditure. Productive expenditure should be prioritized rather than populist schemes such as farm loan waivers, which prove to be a significant drag on state finances. In an uncertain environment, states will have to toe a fine line between fiscal prudence and ensuring economic growth. With multiple states heading into assembly elections over the next two years, they will have to resist the temptation to spend beyond their means.

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WHAT

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AND

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MOREOVER

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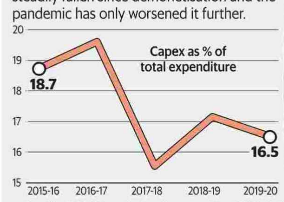
STATE OF THE NATION'S STATES

Chart1: Capital expenditure of the states has steadily fallen since demonetisation and the pandemic has only worsened it further.



Data for 2018-19 is revised estimates and for 2019-20 is budget estimates.

Chart2: States have become more dependent on the Centre for their finances

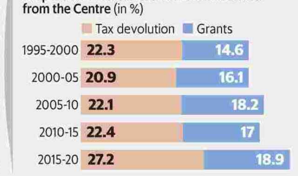
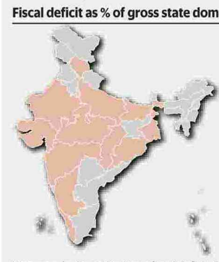


Chart3: Many states have seen their fiscal deficit cross the 3% threshold



Fiscal deficit as % of gross state domestic product	2019-20	2020-21	2021-22
Bihar	2.0	6.8	3.0
Chhattisgarh	5.2	6.5	4.6
Gujarat	1.5	3.1	1.6
Karnataka	2.3	3.2	3.5
Kerala	2.8	4.3	3.5
Madhya Pradesh	3.6	5.5	4.5
Maharashtra	1.9	3.3	2.2
Odisha	3.6	3.5	3.5
Rajasthan	3.8	6.1	4.0
Uttar Pradesh	-0.7	4.2	4.2
West Bengal	2.9	3.9	2.9
Himachal Pradesh	3.4	4.1	4.5

States marked in red indicate fiscal deficit above 3%
Note: 2019-20 data is actuals, 2020-21 is revised estimates and 2021-22 is budget estimates.
Source: RBI report on state finances (2019); SBI research, PRS Legislative Research