Insight beyond information

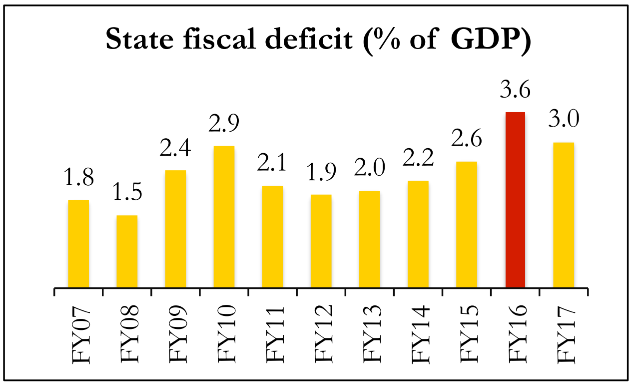
EXECUTIVE BRIEFINGS
POLICY AND ECONOMY: STATE FINANCES

Adit Jain, IMA India
June 2017

A need for restraint

The Government of Indian has since 2014, worked consciously to reduce its fiscal deficit from a worrying 4.8% in the previous year to a more reasonable 3.2% now. This was no easy task since it involved tricky expenditure reallocations and improvements both in its spending agenda as well as its efficiency of output. The markets acknowledged this notable effort and the currency, formerly under bouts of bear hammering, stabilised. The Reserve Bank, in recognition of fiscal prudence, began finally to reverse its interest rates cycle. Consequently, inflation fell to acceptable levels. Despite all of this, rating agencies, whilst having turned more positive on their outlook, have refused to revise their scores meaningfully. There are two reasons for this. First, India's colossal banking debt continues to hog the economic system. Second, the finances of India's states having improved for many years slipped seriously and the overall dissaving of the Union of India has spiked.

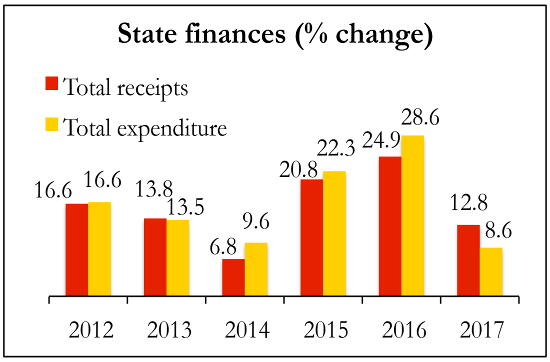
What could aggravate the problem is the fact that the central government implicitly guarantees bonds issued by the states. Consequently, the relatively low costs of borrowing do not deter their desire to spend. With the bond markets, usually the factor for restraint – through higher interest rates – at least for now out of the way, the states have increased their outlays and currently spend even more than the central government and occasionally unwisely. In the years to come, the states will have larger discretionary resources at their disposal both as a result of the new revenue-sharing formula vis-à-vis central taxes as well as the introduction of GST. Their fiscal position will therefore have a greater bearing on macroeconomic outcomes than in the past and a closer inspection of their performance would therefore seem warranted. This note examines some pertinent imperatives.



Source: 'State Finances, A Study of Budgets 2016-17', RBI, CEIC, IMA India analysis

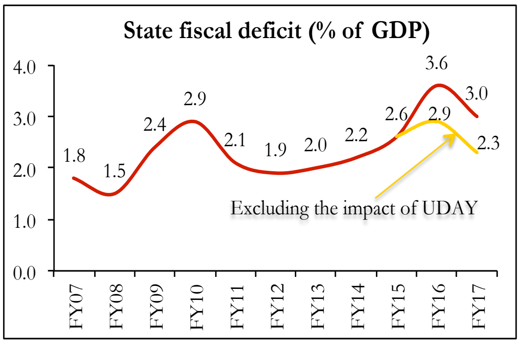
Since GFC II, state Governments, like the centre, worked hard to reduce their deficit, bringing it down from 2.9% of GDP in FY10 to around 2% over the next 4 years. Thereafter, while the centre continued to consolidate, state finances began slipping with their deficit inching up to 2.6% in FY15 followed by a drastic jump to 3.6% in FY16 (see chart). The crossing of the 3% level was bothersome as that is the upper limit mandated under fiscal responsibility laws for state Governments and is considered a threshold for long term fiscal sustainability. At first glance, these findings would seem surprising in view of the fact that since FY16 the centre increased the proportion of tax revenues that it shares with the states, to 42% from 32%, as per the recommendations of the 14th Finance Commission. However, what is not as well appreciated is that, concomitantly, it was resorting to an increased use of cesses and surcharges that are not included in the divisible pool of resources. As a result, states' *effective* share in taxes increased by 7.7% instead of the full 10%.

Further, as part of the higher revenue sharing arrangement, the Centre reduced its contribution in terms of scheme-specific grants and transfers as these expenditures were now supposed to be taken up by the states. The increased rate of tax devolution was therefore intended not so much to give states more money *per se* but to give them more flexibility by increasing their share of discretionary funding. The net result of these changes was that while states did get a revenue boost of 24.9% due to the higher tax sharing ratio, they also suffered a higher expenditure burden (28.6%) to compensate for reduced scheme-specific grants (see chart). This was one of the reasons for the increase in their fiscal deficit in FY16.



Source: 'State of State Finances', PRS, CEIC, IMA India analysis

However, a bigger driver of the rising fiscal mismatch has been the Ujjwal Discom Assurance Yojana, UDAY, a debt rehabilitation programme for state power utilities (discoms), launched in November 2015. States signing up were required to take over 75% of their electricity utilities' debt (estimated at Rs 4 trillion) over a two year period. This was to be done by issuing bonds to the market or directly to the original lenders. Since its launch, states have issued 'discom bonds' worth Rs 2.3 trillion, thereby adding a large amount of debt that was previously unrecognised, (off-balance sheet) to their books. However, one of the incentives for joining the scheme was that this amount would not be included in states' deficit calculation for the purposes of FRBM (Fiscal Responsibility and Budget Management) adherence. Accordingly, if one were to exclude the impact of UDAY, the aggregate state deficit in FY16 would stand reduced from 3.6% of GDP to 2.9% and the budget estimate for FY17 from 3.0% to 2.3% (see chart). These would seem to be more reassuring figures, a conclusion also reached by recent RBI reports on the subject as well as the NK Singh Committee that is drafting the new Fiscal Responsibility and Budget Management Act, 2017 to replace the existing 2003 Act.



Source: 'State Finances, A Study of Budgets 2016-17', RBI, CEIC, IMA India analysis

Nevertheless, whilst there is no compelling cause for panic there are several downside risks to guard against. The first of course, relates to UDAY itself. Despite the bonds themselves being excluded for prudential calculations, the fact remains that reforms with respect to tariff adjustments and efficiency gains still need to be executed. If not, state utilities will incur further losses in the future, half of which their Governments will be obliged to bear. This would increase the burden beyond what is currently anticipated. Secondly, if states decide to implement the recommendations of their own pay commissions in FY18, their staff expenditure would increase. The third risk stems from states' growing tendency to announce arbitrary loan waivers. The Uttar Pradesh Government recently announced one while the Maharashtra Government is considering one of its own. Besides vitiating the credit culture and penalising honest borrowers, such measures impose a significant burden on the state balance sheet since the state is obliged to compensate lending banks. Finally, substantially large market borrowings needed to finance unanticipated liabilities may nudge bond markets to push up yields thereby increasing the cost of debt. Whilst the GST is expected to deliver revenue gains, these may not accrue immediately. For all these reasons, state finances need to remain under close scrutiny. Fiscal autonomy is a worthy objective but not if it collapses into fiscal *profligacy*. It would be tragic if in the name of 'fiscal federalism' the gains achieved by the central Government were frittered away by the states.