V Way Forward

5.1 The fiscal position of state governments in India improved significantly since 2004-05 after the implementation of fiscal rules through the enactment of Fiscal Responsibility and Budget Management (FRBM) Acts / Fiscal Responsibility Legislations (FRLs) and introduction of debt and interest relief measures by the Central Government. These initiatives were also supported by a favourable macroeconomic environment following the high growth phase and a reversal of the interest rate cycle in the mid-2000s.

5.2 In the recent period, particularly during the last couple of years, signs of fiscal stress have re-emerged on the back of poor performance of state public sector enterprises (SPSEs). The recent initiative by several state governments of assuming additional debt liabilities as part of financial and operational restructuring of state power distribution companies (through issuance of UDAY bonds) has led to deterioration in fiscal health of states. This has been reflected in the worsening of key fiscal indicators. It is expected that states will take necessary steps to renew their efforts towards fiscal consolidation and reduce their liabilities.

5.3 The Central Government accepted the recommendations of the Fourteenth Finance Commission (FC-XIV) to increase the states' share in the divisible pool of taxes to 42 per cent (earlier 32 per cent) from 2015-16 onwards. This did lead to greater predictability and certainty in the quantum of funds being transferred to the states; additionally, there has been an overall increase in untied funds. As a result, the share of states in central taxes increased by 1.1 percentage points of GDP in 2015-16 (RE) over the previous year. The increasing use of special levies (*viz.*, cess, surcharge and other additional/special duties) by the Central Government, however, resulted in a reduction in the divisible pool of taxes as these levies are not shared with state governments, although they did boost the Central Government's tax revenue. As a result, despite increase in the share of states in the divisible pool of resources from 2015-16 by 10 per cent following the FC-XIV's recommendation, the states' share in Centre's gross tax revenue has *de facto* increased by only 7.7 per cent – from 27.1 per cent in 2014-15 to 34.8 per cent in 2015-16. It is expected that most of the cesses will be subsumed in the GST, which will increase the size of the divisible pool of resources to the advantage of the states.

5.4 While conventional debt sustainability analysis reveals that state governments' debt is sustainable in the long run, several related developments which have a bearing on the debt/fiscal sustainability of states over the medium term need to be taken into account for a balanced assessment. First, the guarantee commitments of state governments in respect

of SPSEs have recently emerged as a major source of potential risk to debt sustainability. Unbridled growth in these guarantees constitutes a major fiscal risk given the SPSEs large outstanding debt and losses (particularly those in the power sector) (IMF, 2016; Kaur *et al.,* 2014). Second, the interest liabilities of states that have participated in financial restructuring of DISCOMs (through UDAY) would increase, going forward. Moreover, additional provisions are required to be made by the state governments for extending financial support to these utilities in case they continue to incur losses in future. Third, the committed liabilities of states may increase in case they decide to implement the recommendations of their own pay commissions in 2017-18. Since their own tax revenue is inadequate to finance the additional burden, states may take recourse to market borrowing for additional funds, with implications for debt sustainability. Fourth, many states (particularly the fiscally prudent ones), which were earlier refraining from seeking additional funds through market borrowing, may now borrow as per the criteria of additional borrowing indicated by the FC-XIV.

5.5 Yet another dimension is the *ad hoc* nature of various types of loan waivers announced from time to time by state governments. Such initiatives could add to their fiscal burden and affect their finances over the medium term. While these loan waivers could alleviate the immediate debt burden of financially distressed farmers, it is essentially a transfer from tax payers to borrowers with an adverse bearing on the fiscal viability of states. Moreover, it impacts credit discipline, vitiates credit culture and dis-incentivises borrowers from repayment, thus engendering moral hazard with expectations of future bailouts. Furthermore, if overall government borrowings increase, as is likely due to issuance of debt relief bonds by state governments, yields on state development loans (SDL) may firm up posing a higher interest burden in the future. Concomitantly, it can also crowd out private borrowers, given the finite pool of investible resources in the economy.

5.6 The consolidated GFD-GSDP ratio of 25 states is budgeted at 2.6 per cent for 2017-18, lower than the Central Government's budgeted gross fiscal deficit to GDP ratio at 3.2 per cent. Even as the Central Government makes significant efforts toward fiscal consolidation, the accumulation of liabilities could result in higher debt burden of the states unless immediate steps are taken to contain them. A rising general government debt-GDP ratio is also detrimental from a sovereign rating perspective. The recently released FRBM Review Committee Report, 2017 (Chairman: N. K. Singh) has recommended that a sustainable debt path must be the principle macro-economic anchor of fiscal policy, consisting of 40 per cent of debt-GDP ratio for the Central Government and 20 per cent for state governments by 2022-23. The states will have to considerably tighten their finances to reach this benchmark, given that their outstanding liabilities to GDP ratio stood at 23.9 per cent at end-March 2017.

5.7 In this context, introduction of the GST is expected to have significant macroeconomic implications in terms of growth, inflation, export competitiveness and the fiscal balance in the years ahead.

The successful implementation of GST will result in additional revenue through simpler and easier tax administration, supported by robust and user-friendly IT systems. The GST is expected to reduce administrative costs for collection of tax revenue and improve revenue efficiency. Moreover, uniformity in tax rates and procedures across the country will economise on compliance cost. It will also lead to increase in the shareable pool of resources, resulting in larger central transfer to the states which, in turn, will enable them to undertake much needed developmental expenditure. Such an outcome would ensure debt sustainability for states in the long term. In fact, the GST is likely to set a new course for cooperative federalism in India by strengthening Centre-state partnership.