I Overview

The key deficit indicators of the consolidated state governments relative to GDP are budgeted to improve in 2013-14, with an increase in revenue surplus contributing to a reduction in the gross fiscal deficit (GFD). Although the development expenditure-GDP ratio is budgeted to decline in 2013-14, it would still be higher than the high growth phase (2004-08) as well as the immediate post-crisis period (2008-10). Notwithstanding the sustainability in the overall debt position of the states, narrowing of the growth-interest rate differential could exert pressure on the debt of certain states in the medium-term. Further, increase in contingent, off-budget and unfunded liabilities of some states could pose risks to fiscal sustainability. An econometric exercise using panel regression for the period 1980-81 to 2012-13 reveals that, at the state level, primary revenue expenditure was acyclical and capital outlay, pro-cyclical. Going forward, central and state governments should work in the spirit of co-operative federalism to remove all legislative hurdles in the introduction of the goods and services tax, which has far reaching implications, both for tax revenues as well as growth. The non-development primary expenditure-GDP ratio needs to be brought down. States which have built large revenue surpluses may utilise the same to increase capital outlay, particularly for building infrastructure, provided they have adequate fiscal space.

1. Introduction

1.1 The fiscal position of state governments indicates continuation of the process of fiscal consolidation which was resumed in 2010-11, consequent to the amendments in their FRBM Acts, in line with the targets set by the Thirteenth Finance Commission (FC-XIII). Fiscal consolidation gained further momentum in 2011-12, with an improvement in all the key deficit indicators at the consolidated level. Revenue surpluses were a result of the combined effect of a reduction in revenue expenditure and increase in own revenues relative to GDP as compared to the post-crisis period (2008-10). However, revenue surpluses declined somewhat in 2012-13(RE) and the GFD-GDP ratio rose on account of increases in capital outlay and development expenditure, even as it remained within the FC-XIII's target. All key deficit indicators are budgeted to improve in 2013-14. Macroeconomic conditions, policy initiatives of the central and state governments and the states' commitment to adhering to the path of fiscal consolidation would shape the eventual fiscal outcome in the medium term. This report on 'State Finances: A Study of Budgets of 2013-14'[1] has been prepared based on the data available in the budget documents of 28 state governments and two union territories with legislature (NCT Delhi and Puducherry), supplemented by data from the Reserve Bank, Government of India and Office of the Comptroller and Auditor General of India.

2. Preview

1.2 The fiscal position of state governments for 2013-14, based on their budget estimates, shows an increase in revenue surplus to 0.4 per cent of GDP. This is driven entirely by a reduction of 0.2 percentage points in the revenue expenditure-GDP ratio. A higher surplus in the revenue account would help reduce the GFD-GDP ratio to 2.2 per cent of GDP despite a marginal increase in the capital outlay-GDP ratio in 2013-14 (BE).

[1] Prepared in the Fiscal Analysis Division of the Department of Economic and Policy Research (DEPR), with support in data compilation received from Regional Offices of DEPR.

1.3 At the disaggregated level, the key deficit indicators are budgeted to improve in both non-special category (NSC) and special category (SC) states in 2013-14 (BE). While 22 states have budgeted for revenue surpluses, 13 states expect to improve their revenue accounts in terms of GSDP. GFD and primary deficit (PD) as ratios to GSDP are budgeted to decline in 16 and 15 states, respectively in 2013-14.

1.4 To increase states' own tax revenue, many states have raised taxes on tobacco and liquor products, besides a few other products, and some states have proposed measures for simplifying tax procedures and for improving tax compliance. Measures on the expenditure front include increased outlays for the power sector to meet commitments under the financial restructuring plan for state power utilities, strengthening the public distribution system (PDS) and creating adequate storage facilities for implementation of the National Food Security Act, besides continuing to accord importance to education, health, agriculture and infrastructure.

1.5 The debt-GDP ratio at the state level declined in 2012-13 (RE), although the pace of reduction slowed down considerably, reflecting the impact of deceleration in nominal GDP growth and the increase in the GFD-GDP ratio. Market borrowings were the predominant component, accounting for 40.2 per cent of the outstanding liabilities of the states. While special securities issued to NSSF accounted for 22.4 per cent of the outstanding liabilities of the states, loans from the centre accounted for only 6.9 per cent. The declining trend in the consolidated debt-GDP ratio is expected to continue in 2013-14, aided by the budgeted decline in the GFD-GDP ratio. However, the ongoing financial restructuring of the state-owned power distribution companies (discoms) would add to the debt and contingent liabilities of participating state governments in the coming years.

1.6 Many state governments have accumulated sizeable cash surpluses in recent years, reflecting the fiscal consolidation process as well as their precautionary motive of building a cushion for their expenditures. Liquidity pressures during 2012-13 were, thus, confined to a few states; eight states availed of normal ways and means advances (WMA), of which six states were in overdraft. The existing normal WMA limits of the states, that help them meet any short-term funding gaps, have been raised by 50 per cent in November 2013 by the Reserve Bank.

1.7 Some of the recent policy initiatives of the central government, like the restructuring of centrally sponsored schemes and the implementation of the National Food Security Act 2013 would entail additional responsibility at the state level. Hence, the finances of the states are not only being shaped by their own policies but also by the policies of the central government. Revenue raising prospects of state governments in the medium-term would be influenced by the introduction of the proposed goods and services tax (GST). However, this is contingent on the constitution amendment bill being passed and subsequently ratified by at least 50 per cent of the states. This would require resolving contentious issues between the centre and the states through mutual confidence building measures/steps.

1.8 On the debt front, although the overall debt position of state governments is sustainable, a slowdown in growth momentum could affect their revenue raising capacity, with adverse implications for incremental debt and debt servicing capacity of some states. Moreover, withdrawal of interest relief for those states which have not adhered to their FRBM targets may increase their debt service burden. Considering the potential risk

to the fiscal and debt sustainability of the state governments that may arise from contingent, off-budget and unfunded liabilities, there is a need for greater fiscal transparency in the disclosure of such liabilities for proper assessment of their financial health.

1.9 Unlike many federal economies where sub-national revenues and expenditure move in line with business cycles, fiscal expenditures of Indian states exhibit different cyclical behaviour across different components as revealed by a panel data analysis covering non-special category states during 1980-81 to 2012-13. While capital outlay is found to be pro-cyclical, primary revenue expenditure turns out to be acyclical as it does not respond to growth cycles. This can be explained by the fact that given the more stringent resource constraints for state governments, the underlying rigidities in adjusting primary revenue expenditures result in the fiscal authorities cutting or expanding capital expenditures in line with growth cycles.

1.10 The increase in development expenditure in recent years is a welcome feature and should be maintained. Going forward, the states may have to focus on cutting down non-development primary expenditure, particularly untargeted subsidies, as the scope for further reduction in the IP-GDP ratio through interest resets may be limited, considering the continued shift towards market borrowings. Further, states may explore ways to increase their non-tax revenue through increases in user charges. Emphasis may also be placed on improving the efficiency of resource use. States which have built large revenue surpluses may utilise these to increase capital outlay, particularly for building infrastructure, provided they have adequate fiscal space.

1.11 The chapter-wise scheme of the report is as follows: While this chapter has provided an overview of the report, major issues relating to the finances of the states are highlighted in Chapter II. Major policy initiatives undertaken by state governments, the Government of India and the Reserve Bank are presented in Chapter III. Chapter IV provides an analysis of the fiscal position at the consolidated level and the underlying state-wise contributions. Chapter V presents an analysis and assessment of the debt position of the states, including market borrowings and contingent liabilities. Chapter VI focuses on the special theme, 'Cyclicality in the Fiscal Expenditures of Major States in India'. The consolidated data on various fiscal indicators of 28 state governments are covered in Appendix Tables 1-13, while state-wise data are provided in Statements 1-34. The detailed state-wise budgetary data are provided in Appendices I-IV (Appendix I: Revenue Receipts, Appendix II: Revenue Expenditure, Appendix III: Capital Receipts, Appendix IV: Capital Expenditure).