



## Fiscal Health of the States

This editorial is based on [A macro view of the fiscal health of States](#) which was published in The Hindu on 05/07/2023. It talks about the fiscal health of Indian States.

**For Prelims:** [Reserve Bank of India's \(RBI\)](#), [Annual Study on State Finances](#), [Covid-19 Pandemic](#), [Fiscal Deficits](#), [GDP](#), [GST\(Goods and Services Tax\)](#), [Finance Commissions](#), [Human Capital](#)

**For Mains:** Fiscal Challenges Faced by Indian States, how can Indian States Reduce their Revenue Deficits

In India, the States mobilize more than a third of total revenue, **spend 60% of combined government expenditure**, and have a **share in government borrowing** that is **around 40%**. Given the size of the fiscal operation of States, an up-to-date understanding of their finances is critical in order to draw **evidence-based inferences on the fiscal situation of the country**.

However, **due to the absence of aggregation** of individual **State Budget data**, a consolidated view of general government finances is not readily available. Every year, this data becomes available only after the publication of the [Reserve Bank of India's \(RBI\) Annual Study on State Finances](#), which has **revealed the fiscal situation of States based** on key data from their **individual budgets for 2023-24**.

The data are from **17 major States that account for more than 90%** of the total spending of all States. Therefore, the fiscal issues from their budgets reflect the State finances in India. Indian States have shown remarkable fiscal consolidation after the Covid-19 pandemic, but they still face fiscal challenges in containing their revenue deficits.

### How have Indian States Performed in Fiscal Consolidation?

#### ▪ Fiscal Consolidation:

- Fiscal consolidation **refers to the process of reducing fiscal deficits and public debt** by adjusting expenditure and revenue policies.
- Indian States **have achieved significant fiscal consolidation** after the **Covid-19 pandemic**, reducing their **fiscal deficits** from **4.1% of GDP(Gross Domestic Product) in 2020-21 to 2.9% of GDP in 2023-24 (BE)**.

#### ▪ Fiscal Consolidation is Significant:

- States managed to be **fiscally prudent despite a contraction** in revenues during the peak of Covid-19.
- States coordinated with the Union Government **to provide emergency provision for health spending** and livelihood during the pandemic.
- States **reprioritized expenditure and quickly contained** the fiscal deficit.
- States benefited from **improved [GST\(Goods and Services Tax\)](#) collection and higher tax devolution** due to buoyant central revenues.

- States also **witnessed recovery in non-GST revenues** after the pandemic.

## What are the Fiscal Challenges Faced by Indian States?

- Despite the **reduction in fiscal deficit**, Indian States still face fiscal challenges, especially in **containing their revenue deficits**, which have **not declined proportionately** with fiscal deficits.
  - Revenue deficit **refers to the excess of revenue expenditure over revenue income in a financial year.**
  - **Revenue Related Challenges:**
    - The impact of the **Covid-19 pandemic on the economic activity** and tax collection.
    - The **uncertainty and volatility of GST revenue and compensation.**
    - The **dependence on tax devolution** from the Union and its formula-based allocation.
    - The erosion of fiscal autonomy due to the subsumption of various taxes under GST.
    - The **limited scope for raising non-tax revenues** such as user charges, fees, etc.
    - The **compliance and administrative issues** in collecting own taxes such as property tax, stamp duty, etc.
- **Major Revenue Deficit States:**
  - Out of 17 major States, **13 States have revenue deficits**, and **seven States have revenue deficits** as the main driver of their fiscal deficits.
    - These States are Andhra Pradesh, Haryana, Kerala, Punjab, Rajasthan, Tamil Nadu, and West Bengal.
    - They also **have large [debt to GSDP ratios](#).**
- **Expenditure Related Challenges:**
  - The **rising demand for public health and education** services due to the pandemic and demographic factors.
  - The **need to invest in infrastructure and urban development** to support growth and employment.
  - The **fiscal implications of various welfare schemes** and subsidies for the poor and vulnerable sections.
  - The **burden of pension and salary liabilities** for the public sector employees.
  - The **contingent liabilities** arising from guarantees, loans, etc. given to public sector enterprises and other entities.
  - The **sustainability and servicing of the debt stock** accumulated over the years.

## What are the Factors for Re-emergence of Revenue Deficit?

- Pressure on **revenue expenditure due to Covid-19 pandemic** and other **social welfare schemes.**
- **Slowdown in economic growth** and tax revenues **due to structural and cyclical factors.**
- **Inadequate compensation for GST** shortfall by the Union Government.
- Rigidities in revenue expenditure **due to committed liabilities**, such as salaries, pensions, interest payments, etc.

## How can Indian States Reduce their Revenue Deficits?

- Indian States can reduce their revenue deficits by various measures, such as:
  - **Reducing public expenditure**, especially **on non-productive or unnecessary items**, such as excessive subsidies, administrative costs, etc.
  - Increasing revenue, especially **from tax and non-tax sources**, such as improving tax compliance, widening the tax base, **rationalizing tax rates, or increasing the income of [public sector undertakings](#)**, etc.
  - Achieving faster economic growth, which can boost revenue collection and reduce expenditure on social welfare schemes.
  - Linking **interest-free loans or grants** from the Union Government to revenue deficit reduction targets, which **can create an incentive** for fiscal discipline.

- Implementing performance incentive **grants for revenue deficit reduction**, based on the approaches **suggested by previous [Finance Commissions](#)**.

## What are the Benefits of Reducing Revenue Deficits for Indian States?

- Improving the **fiscal health and sustainability** of State finances and reducing their debt burden.
- Enhancing the **quality of expenditure and increasing the share of capital expenditure** in total expenditure.
- Boosting **public investment in infrastructure** and **human capital**, which can foster economic growth and development.
- Strengthening the credibility and confidence of investors and creditors in State finances.
- Ensuring **macroeconomic stability and coordination** with the Union Government.

## What Should be the Way Forward?

- **Adopting a Credible and Sustainable Fiscal Adjustment Plan:**
  - Balance short-term and long-term fiscal objectives
  - Take into account economic and institutional context of each State.
  - Identify and implement cost-cutting and revenue-enhancing measures.
- **Improving Fiscal Transparency and Accountability:**
  - Provide timely and reliable data on budgetary performance and outcomes.
  - Adhere to fiscal rules and targets prescribed by Finance Commissions and FRBM Acts.
  - Monitor and evaluate fiscal performance and outcomes regularly.
- **Enhancing Fiscal Capacity and Autonomy:**
  - Rationalize tax structure and administration
  - Diversify revenue sources
  - Leverage assets and resources
  - Access market borrowings at competitive rates
- **Fostering Fiscal Cooperation and Coordination:**
  - Resolve pending issues related to GST compensation and devolution
  - Harmonize fiscal policies and indicators
  - Participate in intergovernmental forums and mechanisms.
  - Share best practices and experiences

## What is FRBM Act?

- **About;**
  - It was enacted in August 2003.
  - It aims to make the Central government responsible for ensuring inter-generational equity in fiscal management and long-term macro-economic stability.
  - The Act envisages the setting of limits on the Central government's debt and deficits.
  - It limited the fiscal deficit to 3% of the GDP.
  - To ensure that the States too are financially prudent, the 12th Finance Commission's recommendations in 2004 linked debt relief to States with their enactment of similar laws.
  - The States have since enacted their own respective Financial Responsibility Legislation, which sets the same 3% of Gross State Domestic Product (GSDP) cap on their annual budget deficits.
- It also mandates greater transparency in fiscal operations of the Central government and the conduct of fiscal policy in a medium-term framework.
- The Budget of the Union government includes a Medium-Term Fiscal Policy Statement that specifies the annual revenue and fiscal deficit goals over a three-year horizon.
- The rules for implementing the Act were notified in July 2004. The rules were amended in 2018, and most recently to the setting of a target of 3.1% for March 2023.
- The NK Singh committee (set up in 2016) recommended that the government should target a fiscal deficit of 3% of the GDP in years up to March 31, 2020, cut it to 2.8% in 2020-21 and to 2.5% by 2023.
- **Relaxation under the FRBM Act**
  - Escape Clause:

- Under Section 4(2) of the Act, the Centre can exceed the annual fiscal deficit target citing certain grounds.
  - National security, war
  - National calamity
  - Collapse of agriculture
  - Structural reforms
  - Decline in real output growth of a quarter by at least three percentage points below the average of the previous four quarters.

**Drishti Mains Question:**

Indian States have shown remarkable fiscal consolidation after the Covid-19 pandemic, but they still face fiscal challenges in containing their revenue deficits. Discuss the causes and consequences of revenue deficits for Indian States.

**UPSC Civil Services Examination Previous Year's Question (PYQs)**

**Prelims:**

**Consider the following statements: (2018)**

1. The Fiscal Responsibility and Budget Management (FRBM) Review Committee Report has recommended a debt to GDP ratio of 60% for the general (combined) government by 2023, comprising 40% for the Central Government and 20% for the State Governments.
2. The Central Government has domestic liabilities of 21% of GDP as compared to that of 49% of GDP of the State Governments.
3. As per the Constitution of India, it is mandatory for a State to take the Central Government's consent for raising any loan if the former owes any outstanding liabilities to the latter.

**Which of the statements given above is/are correct?**

- (a) 1 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

**Ans: (c)**

**Mains:**

**Q:** Public expenditure management is a challenge to the Government of India in the context of budget-making during the post-liberalization period. Clarify it. **(2019)**