Emerging Issues in State Finances Post-Fourteenth Finance Commission:

Analysis of State Budgets 2016-17

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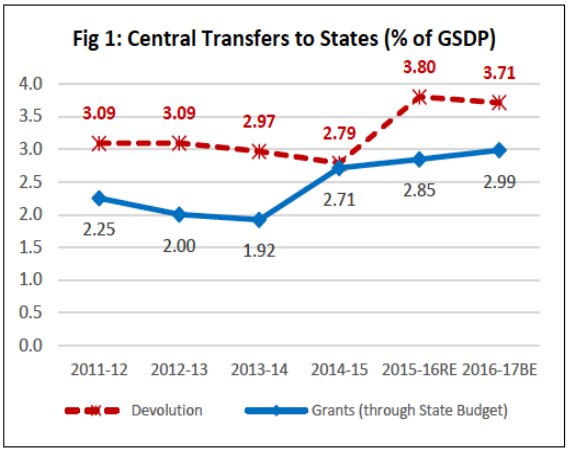
In the last two years intergovernmental fiscal relations in India have changed considerably following the implementation of the Fourteenth Finance Commission's (FFC) recommendations and subsequent restructuring of grants by the Union Government. The Government of India replaced the Planning Commission with a new institution called the NITI Aayog, with an objective of bringing "States to act together in the national interest, and thereby foster Cooperative Federalism". The other major development is the 122nd Constitutional Amendment to introduce Goods and Services Tax (GST) in India. GST is expected to develop a common market through a simplified tax structure. In addition to this, Government of India has launched an ambitious scheme, the Ujwal DISCOM Assurance Yojana (UDAY) to improve operational and financial transformation of the electricity distribution companies. These policy developments have implications on finances of state governments both in the short run and in the long run.

The study, using state budgets-2016-17 analyses how states have adjusted to these changes and what are the likely impact of these on finances of state governments. Our analysis quantifies the effect of enhanced devolution recommended by FFC and grants restructuring by the Union government on states' fiscal space. Any change in the fiscal space of states will have implications for social sector/ human development financing. Our analysis also examines the implications of these policy changes on expenditures of states especially, social sector expenditures. The following points emerge from our analysis:

Tax devolution as percentage of GSDP[1] has increased for all states in 2015-16RE as compared to 2014-15-the terminal year of the Thirteenth Finance Commission award (See Fig 1). Grants aggregated across all states (through state budgets) as percentage of all state GSDP also show a similar trend (Fig 1). However, if we add to it the grants that were going directly to state implementing agencies bypassing the state budgets, we find total grants as a percentage of GSDP have in fact declined (Fig 2). This is not surprising given the restructuring of grants to accommodate enhanced tax devolution.



However, if we compare transfer to GSDP ratio between 2011-12 and 2016-17BE, it declined sharply from 6.76 per cent in 2011-12 to 5.67 per cent in 2014-15 (Fig 3). Post FFC award there is a significant increase in transfer to GSDP ratio by more than 1 percentage points. The composition of central transfers has also undergone a change during this period. Due to the increase in devolution to 42 per cent of shareable taxes, untied and formula based transfers (i.e., tax devolution) have become the dominant form of transfers account-

[1]GSDP number used in the analysis is at current prices-2011-12 series.

National Institute of Public Finance and Policy, New Delhi. IDRC project on 'Intergovernmental Fiscal Transfers in India'.

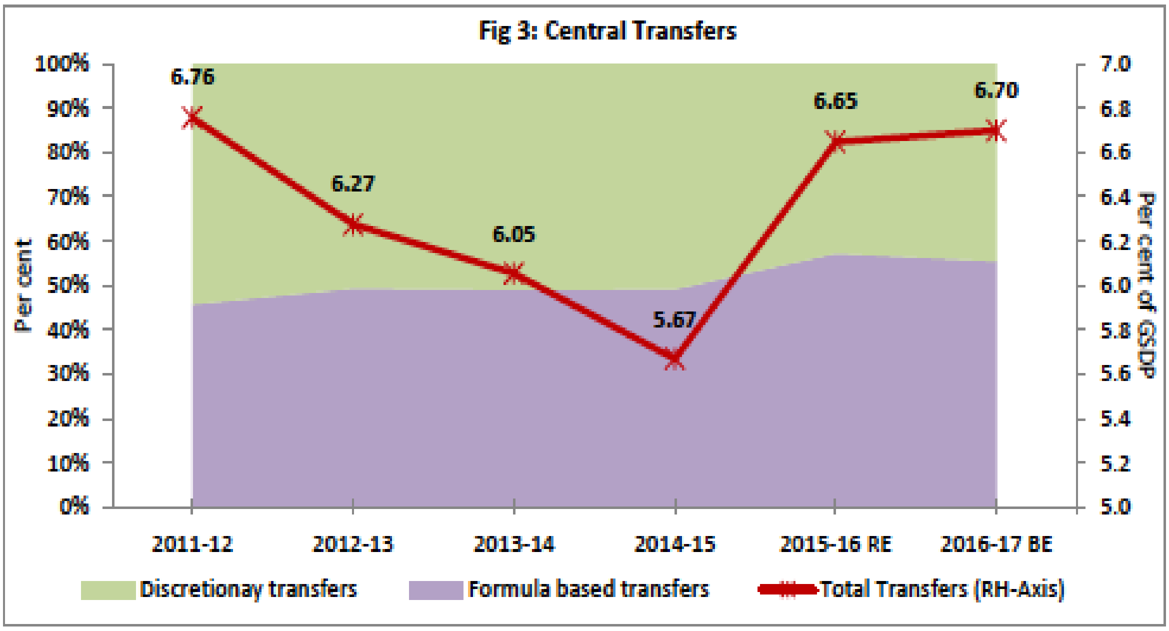


Fig 3: Central Transfers

ing for about 55.4 per cent of total central transfers to state governments in 2016-17BE. Chakraborty and Gupta (2016)[2] estimated that the share of untied transfers in total transfers would be around 75 per cent in 2016-17BE if we add untied grants[3] with tax devolution.

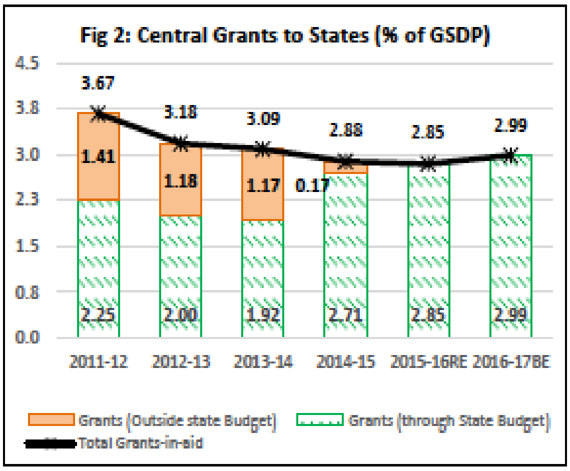


Fig 2: Central Grants to States (% of GSDP)

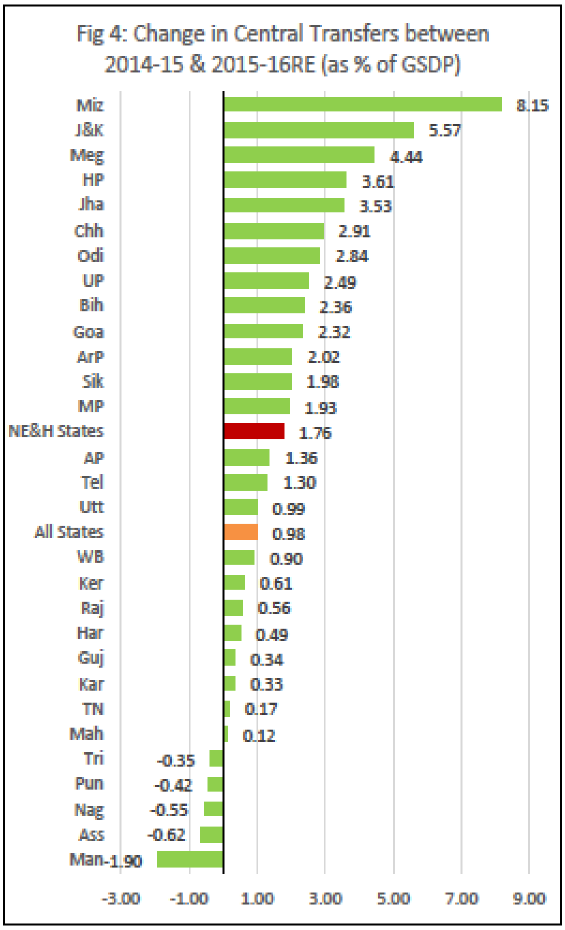
State-wise analysis reveal that while all states benefitted from the increase in tax devolution in 2015-16RE and 2016-17BE as compared to 2014-15, many of them experienced a reduction in central grants during this period. State wise combined effect of increased devolution and reduction in central grants is presented in Figure 4 and 5.

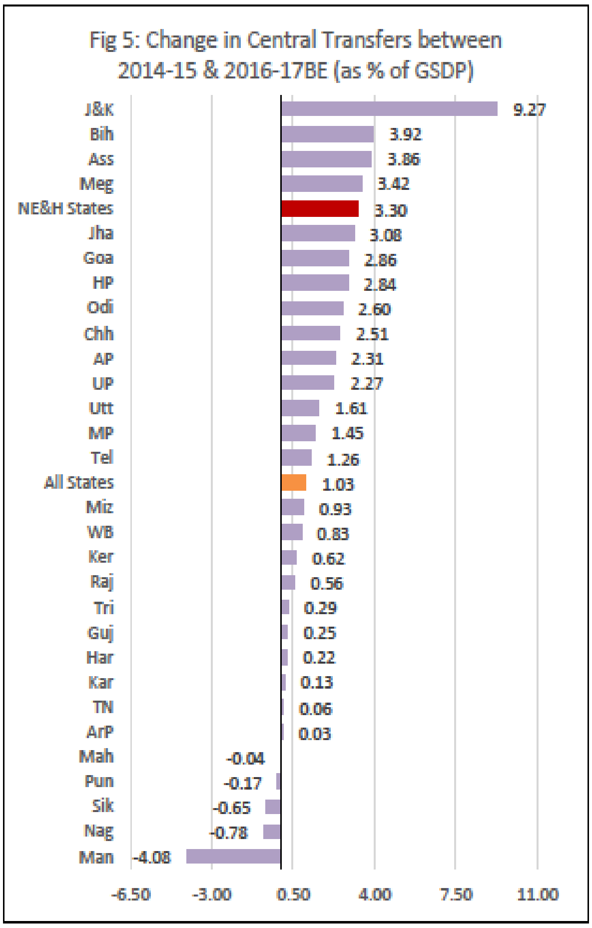
If we focus our attention to own revenues of states, we find that there has been a decline in their own revenues as percentage of GSDP between 2011-12 and 2015-16RE mainly due to the fall in own tax revenues. Between 2014-15 and 2015-16RE own revenues as percentage of GSDP have declined in Goa, Gujarat, Karnataka, Madhya Pradesh, Kerala, Rajasthan, Tamil Nadu, West Bengal, Arunachal Pradesh Himachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura.

Both revenue expenditure and capital expenditure as percentage of GSDP aggregated across all states show an increasing trend during the period 2011-12 to 2015-16RE. In 2016-17BE, total expenditure as percentage of GSDP is budgeted to decline to 17.13 per cent as compared to 17.44 per cent in 2015-16RE while capital expenditure is budgeted to marginally increase to 2.84 per cent from 2.81 per cent in 2015-16RE. Expenditures on social services, economic services, education and health as

2 Chakraborty, Pinaki and Manish Gupta (2016): "Evolving Centre–State Financial Relations: Role of the New Framework for Grants", Economic and Political Weekly, Vol 51, No. 16, pp. 43-46

3 Some of the large untied grants are revenue deficit grants and local body grants of Finance Commission. Two thirds of local body grants of TFC and around 87% of FFC local body grants were untied.





percentage of GSDP also show an increasing trend during 2011-12 and 2016-17BE. However, there are variations across states. Expenditures as percentage of GSDP have declined in a number of states in 2015-16RE as compared to 2014-15. States where total expenditures have declined in 2015-16RE vis-à-vis 2014-15 are also the states where there is a reduction in total revenue receipts to GSDP ratio. Mizoram being the only exception where despite an increase in total revenue receipts to GSDP ratio in 2015-16RE over 2014-15, total expenditure as percentage of GSDP has declined. States where capital expenditures (as percentage of GSDP) have declined are Gujarat, Karnataka, Mizoram and Uttarakhand. Considering expenditure on social services, education and health, we find that such expenditures as percentage of GSDP have declined in 2015-16RE as compared to 2014-15 in the following states: West Bengal and Meghalaya (social services and education), Manipur (social services and health), Tripura (social services), Karnataka, Kerala, and Mizoram (education) and Arunachal Pradesh (health).

Looking at the key deficit indicators we find a deterioration in the fiscal position of states from 2013-14. Surpluses on the revenue account in the earlier years turned into deficit and we have re-emergence of revenue deficit in 2013-14. The finances of states further deteriorated in the following year i.e., in 2014-15. In 2015-16RE, all states' revenue deficit as percentage of GSDP was -0.23 per cent and the revenue account is budgeted to be in surplus to the tune of 0.13 per cent in 2016-17BE. A number of states which had revenue surplus in 2011-12 reported revenue deficits in 2013-14 (6 states) or in 2014-15 (10 states) or in both the years (5 states - Chhattisgarh, Himachal Pradesh, Mizoram, Rajasthan and Tamil Nadu). However, fiscal deficit aggregated across all states during this period was well within the targets under the Fiscal Responsibility Act (FRA). In 2015-16RE, all state FD is expected to increase to -3.63 per cent of GSDP and is budgeted to be -2.87 per cent in 2016-17BE. The number of states having fiscal deficit greater that 3 per cent increased from 9 in 2011-12 to 14 in 2014-15, 2015-16RE and 2016-17BE.

Outstanding liabilities aggregated across all states as percentage of GSDP have declined from 23.60 per cent in 2011-12 to 22.31 per cent in 2014-15. In 2015-16RE outstanding liabilities marginally increased to 22.80 per cent of GSDP and is budgeted to be around 22.74 per cent in 2016-17BE. The reduction in outstanding liabilities was accompanied by a reduction in aggregate interest payment to total revenue receipts (IP/TRR) ratio. IP/TRR ratio declined from 0.125 in 2011-12 to 0.107 in 2015-16RE and was budgeted to be 0.111 in 2016-17BE. Interest payment as percentage of GSDP declined from 1.65 per cent 2011-12 to 1.58 per cent in 2015-16RE and was budgeted to increase marginally to 1.59 per cent in 2016-17BE.

To conclude, post-FFC award there has been an increase in untied fiscal space of states in aggregate, though a few states have observed a decline in transfers when 2014-15 actual data is compared with the 2016-17(BE). Secondly, fiscal correction witnessed in states finances, post FRA in terms of reduction in revenue and fiscal deficit seem to have weakened from 2013-14 with the re-emergence of revenue deficit in many states and increase in the fiscal deficit above 3 per cent of GSDP. In this scenario, downside fiscal risks are many including the impending 7th Pay Commission award at the state level, debt servicing burden that may arise due to the UDAY scheme in selected states and a decline in states' own revenue effort. Given the expenditure level, an early introduction of GST and increase in revenue effort are critical to reverse this trend.