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## STATE FINANCES

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# Is fiscal prudence really fading away?

The concerns pertaining to state finances should centre around the restoration of revenue account balance not the level of fiscal deficit, which without UDAY remained well within limits

**R**ESERVE BANK OF India (RBI) study on "State Finances: A Study of Budgets of 2016-17" has just been published. An important yearly central bank publication it provides a consolidated view of the fiscal health of states. Generally, it is published in the month of December. But this particular report was delayed by a couple of months. The delay in the publication was probably to capture the evolving Goods and Services Tax design being negotiated in the GST council. The state finances report reflects the fiscal position of states in detail for the year FY15, revised estimates for FY16 (RE) and budget estimates FY17 (BE). It is particularly important for three reasons: (a) this is the first report which provides an understanding of what has happened to state finances post Fourteenth Finance Commission with more reliable data of FY16 at the RE level; (b) it provides some understanding of revenue gain from GST, taking into consideration an almost final GST design; (c) it captures the effect of Ujjawal Discom Assurance Yojana (UDAY) on states' fiscal imbalance. This report is a well-researched piece of work and provides useful insights on emerging issues in state finances in India.

## Fiscal imbalance

An analysis of state budgets shows that consolidated fiscal deficit of states will be above the Fiscal Responsibility and Budget Management (FRBM) target in FY16 (RE) and is expected to revert to the mandated FRBM target of 3% by FY17 (BE). The central bank study cautions that this may not happen given the chance of fiscal slippages in the year FY17. The reason for fiscal deficit target overshooting in the year FY16 (RE) is the borrowing of ₹990 billion under UDAY by eight states during FY16. This works out to 0.7% of gross domestic product (GDP). Excluding UDAY bonds, deficits will be below the mandated FRBM target of 3%. The report further observed that states have started borrowing more in recent years compared to the period between FY06 to FY12, which is a reflection of rising fiscal imbalance.

It is true that rising fiscal imbalance has the potential to derail fiscal consolidation at the general government level. However, this increase in deficit needs to be seen from a different perspective. We should not forget that state governments were borrowing and not spending in a period when the actual fiscal deficit was well below the FRBM target. States in the post-Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) period generally is extremely cautious in spending, as reflected in their overcorrection of deficits. This has, in turn, depressed capital spending in many states in the past. This spending inertia had also contributed to a large accumulation of cash surplus holdings by the states in the past. RBI's "Study on State Finances: 2011-12" observed that:

The surplus cash balances of the states stood at ₹852 billion as on March 11, 2012. These cash balances get automatically invested in the central government's 14-day intermediate treasury bills as well as in auction treasury bills (ATBs) where states are non-competitive bidders, without any ceilings/limits. Consequently, there is a spillover of the surplus position of the states to the liquidity position of the Centre. The build-up (and volatility) of the central government's cash surplus, in turn, reflects the unintended absorption of liquidity from the banking system which poses a challenge to the reserve bank's monetary management.

The same study also pointed out that in its report submitted in FY10, the Thirteenth Finance Commission "advised the state governments to first utilise their cash balances before taking recourse to fresh borrowings, to finance their deficits

so as to reduce the interest burden." However, in practice, this did not happen. Thus, the recent increase in fiscal deficit needs to be seen from the perspective of capital spending in states. If this increase in borrowing resulted in an increase in capital spending and elimination of the practice of holding cash surplus, we need not worry too much about the increase in the non-UDAY part of the deficit.

## A shift in focus: revenue deficit & capital spending

If we consider an aggregate picture of capital spending in the states, capital outlay was 1.9% of GDP in 2012-13 and is expected to increase to 2.8% of GDP in FY16 (RE). The report also mentioned that capital expenditure expanded by 1 percentage point of GDP in FY16 (RE) with development expenditure rising faster than non-development spending. At the same time, states have started recording deficits in revenue account since FY14. This increased to 0.4% in FY15 and is expected to be 0.2% of GDP in FY16 (RE). This has primarily happened due to a deceleration in own tax revenue growth in many states. Own tax revenue to GDP ratio remained stagnant at around 7.5% of GDP during the period from FY12 to FY16 (RE). If there is anything that one needs to be concerned about with respect to state finances is the restoration of revenue account balance not the level of fiscal deficit, which without UDAY remained well within limits.

## UDAY scheme and macroeconomic context

While doing fiscal impact analysis of UDAY scheme, we should not forget the asymmetric impact of Ujjawal Discom Assurance Yojana in some states. For example, post-UDAY, Rajasthan's fiscal deficit shot up to more than 9% of gross state domestic product (GSDP) in the year FY16, and the debt to GSDP ratio to 31%. Interest obligation arising out of this large debt itself can create huge fiscal stress for the state in the medium term. This asymmetric impact needs to be factored in any analysis on the impact of UDAY on state finances. Second, since discoms are mostly state-owned and have a large debt, a major part of this debt is with the public sector banks and financial institutions. To the extent power sector debt owed to the banking system is taken over by the state governments, this arrangement provide overdue settlement to the banks and improves bank balance sheet. Finally, if we take a larger view of deficit due to public sector economic activity, to the extent discom debt was due to the power purchase from public sector generation companies, in a way arrangements made under UDAY by nature would be intra-public sector transactions.

## Can GST be the game changer?

As observed in the state finances report, GST impact on the economy and on government revenue would be significant, which has the potential to improve revenue performance of the states. It is expected to reduce compliance cost and improve revenue to support fiscal consolidation. However, as highlighted, a lot would depend on the seamless implementation of GST. Since gains from GST would accrue only in the medium-to-long-term, it is important that states remain fiscally prudent throughout, particularly in managing their revenue account balance. Finally, post-UDAY we are having a fiscal deficit which reflects the impact of power sector debt on state finances. It is time we develop a comparable set of data for deficits to judge fiscal prudence and sustainability at the state level bringing all-encompassing borrowing concept such as public sector borrowing requirements. Probably, Reserve Bank of India is the best institution to take up this challenging task of developing this extremely important data set.

With power sector debt in state governments' books, it is time we bring in an all-encompassing borrowing concept such as public sector borrowing requirements, not fiscal deficit, to judge fiscal prudence and sustainability at the state level

# Not a power statement

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UDAY has improved discom balance sheets, while ensuring cheaper power and higher availability, but operational improvement still has a long way to go

**M**ARTICLE "Fixing Discom's Finances" on July 9, 2015, suggested a way forward for commercial viability. Subsequently, the government introduced a comprehensive program UDAY in November 2015. The scheme comprises three parts: (i) financial re-engineering of debt of ₹4.3 lakh crore; (ii) provisioning of cheap power through the higher availability of coal/swapping of coal, etc, and higher funding towards DDUU/IPDS schemes, (iii) operational improvement by discoms for sustainability. The scheme envisaged that 75% of the debt shall be taken over by the state, of which 50% will be in the first year and the remaining in the second. Although this has improved discom balance sheets and has lowered interest rate by 3-4%, while ensuring cheaper power and higher availability, operational improvement still has a long way to go.

While 27 states/UTs have signed UDAY, analysis has been limited to top-10 states which consume more than 70% of the total energy. Of 26 discoms involved in the 10 states, three in Gujarat have retained highest (A+) category. There has been an improvement in eight (one each in Rajasthan, MP, TN, Maharashtra, UP, Gujarat, two in AP), 12 have maintained status quo (Punjab, all four in Karnataka, two in Rajasthan, three in UP, one in Telangana & one in MP). But three (one each in MP, Telangana & UP) have slipped from their earlier rating. Thus, an analysis of rating shows that there has been no improvement in six States comprising 15 discoms (catering to 50% energy). Thus, issues need to be addressed without further loss of time to have a turnaround of discoms in the shortest possible time.

Consumer metering, billing and collection efficiencies continue to be dismal, particularly in Rajasthan, UP & MP, where AT&C losses have increased in FY16 even reaching 45% in some cases. Billing efficiency of certain discoms is as low as 68%. Thus, technology needs to be implemented to enhance the efficacy of billing and collection. Cost coverage ratios, which basically indicate the cash flow situation of a discom, are as low as 70% leading to 30% revenues remaining unrealised even after accounting for subsidies.

Moreover, despite power being available for ₹2.50-₹3.00, average procurement price for some has been ₹4.50 per unit. Distribution system operation and specialised power procurement group do not exist in many discoms. This shall become more critical with higher penetration of renewable energy in future.

Also, technology penetration is low in distribution segment. State of the art control centre for switching, control, operation and automatic fault detection and rectification are absent.

Many of the discoms have negative net worth and accounts are not prepared on time. This results in poor credit rating; thus, borrowing is difficult as well as borrowing costs are high. This creates a utility spiral and it is difficult to come out of it. Methodology needs to be worked out in a time bound manner to make them solvent.

The average subsidy is over 12% of revenue for discoms. For instance, in Gujarat, the subsidy has increased from ₹727 crore from March 2010 to ₹4,664 crore in March 2016. An absence of disbursement from states would seriously affect the operation/cash flow as power procurement costs are as high as 75-80% of the electricity cost. That's why many discoms prefer long-term purchase on deferred payment basis, even though it is costlier than short-term payments which require payments in advance. The success of direct money transfer schemes in other sectors needs to be replicated in electricity at the earliest to improve the cash flow.

The most crucial factor for the success of the distribution system lies with effective regulatory mechanism.

Although it has been more than a year since its implementation, but operational improvement has not been commensurate with the requirement. Financial re-engineering shall ease out the operation of discoms for some time, thus, time is running out to capture this advantage to a sustainable position.

Despite power being available for ₹2.50-₹3 per unit, average procurement price for discoms has been ₹4.50 per unit