ISSN : 2395-4132

THE EXPRESSION

An International Multidisciplinary e-Journal

Bimonthly Refereed & Indexed Open Access e-Journal

The Expression Journal

Impact Factor 3.9

Vol. 8 Issue 2 April 2022

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www.expressionjournal.com

SRILANKA IN THE MAKING: FINANCIAL STATUS OF INDIAN STATES

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Abstract

India is a union of states wherein the distribution of legislative, administrative and financial powers have been done by the constitution vide Article 245 to 293 & Schedule-VIII. To ensure the financial independence, the financial resources are also distributed by the constitution. However, the constitution does not make a clear cut distribution of financial resources and leaves much to be decided by the central government from time to time. The financial resources which have been placed at the disposal of the states are so meager that they have to look up to the Centre for subsidies and contribution. Further in a democratic set up, government is run by different political parties from time to time at Centre as well as state level. Political parties, including of state level, incorporate various freebies in their manifesto to garner political power which have adverse repercussions on the state finances which are already strained. The same thing happened in our neighboring country-Sri Lanka where the ruling political party included many freebies in its manifesto to woe the voters and upon implementing half of the said commitments, economy of Sri Lanka faced a severe crisis resulting to high inflation, paucity of essential goods, draining of foreign reserve and finally leading to declaration of emergency. If the similar situation continues, it may lead to invocation of bankruptcy clause by the Srilankan government. The situation of many Indian states is similar to Srilanka which may lead to overall financial crisis in our country also. To curb this problem; fiscal responsibility and budget management (FRBM) act, 2003 was passed by the parliament of India inter alia incorporating the maximum fiscal deficit to GDP ratio among other things and incorporated measures to maintain the path of fiscal prudence. However this act could not meet the desired ends but able to limit the borrowing of Centre and states up to some extent. To avoid Srilankan type crisis, it is therefore essential to follow the FRBM act in letter and spirit. The aim of this paper is to analyze the financial powers of Indian states and its financial position to suggest measures for achieving the financial viability by them.

Keywords

Bankruptcy, Crisis, Sound, Devolution, Fiscal, Repercussion, Federation, Discipline, Alleviate.

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Introduction

India was under foreign rule for many centuries which resulted in financial drain of resources of the country. It led to immense poverty and unemployment. When India achieved independence, framers of Indian constitution decided India to be a union of states where both level of govt. were distributed legislative, administrative and financial powers to carry out the functions assigned to them. The constitution of India provides for decentralization of revenue and expenditure at two levels of the Federation, the Union and the States. It specifies the revenue raising power and areas of expenditure broadly on considerations of efficiency based on comparative advantage of the governments at the two levels. An imbalance arises in this process since the Union (Central) government is assigned most of revenue raising power while the State governments are expected to carry out most of the development and welfare oriented expenditure. Hence, the state governments are generally confronted with inadequate resources for meeting their expenditure needs. In the Indian case, the Centre has the authority to decide on broad based and buoyant taxes such as income tax, corporation tax and excise duties while the states have the authority on items like sales tax, stamp duties, entertainment tax, and land revenue most of which are not as buoyant.

India was declared to be a welfare state. To alleviate the problems of people, a lot of welfare schemes were inaugurated by both level of govt. Congress was the main political party ruling at center and state level. Other political parties with different ideologies also emerged on the fore and to garner political power, they started offering freebies through their manifesto and changed the political culture of the country. Many schemes offering freebies were implemented having repercussions on state finances. So financial position of the state impacted and states started borrowing and resorting to deficit budgeting. This situation needs to be controlled to avoid aggravate the situation like Srilanka.

Financial Resources of a State

To understand the current financial position, it is necessary to analyze the available resources assigned to states in the federal structure by the constitution of India.

1. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.

2. Taxes on agricultural income.
3. Duties in respect of succession to agricultural land.
4. Estate duty in respect of agricultural land.
5. Taxes on lands and buildings.
6. Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.
7. Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
8. Taxes on the entry of goods into a local area for consumption, use or sale therein.
9. Taxes on the consumption or sale of electricity.
10. Taxes on the sale or purchase of goods other than newspapers.
11. Taxes on advertisements other than advertisements published in the newspapersand advertisements broadcast by radio or television.
12. Taxes on goods and passengers carried by road or on inland waterways.
13. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III.
14. Taxes on animals and boats.
15. Tolls.
16. Taxes on professions, trades, callings and employments.
17. Capitation taxes.
18. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
19. Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

Grants-in-Aid

The financial resources of the states though includes 19 items for taxation against Centre 12 items are inelastic and in-buoyant and the states are in need of money to run their government, Article 275 of constitution empowers parliament to give financial assistance to the states in need of such assistance. The grants so fixed are based upon the recommendation of the Finance Commission. Article 282 empowers the Centre to make public purpose grants to the states and to any institution within the states. The constitution says that the cost of schemes aiming at welfare of schedule tribes is to be met by the union govt and the union govt makes the necessary grants on this account to the states (Swain-P 450).

Deficit Financing

The various sources of fund to finance economic development in the modern states besides ibid sources is borrowing. When the govt does not raise sufficient resources through taxation, it resorts to deficit financing to meet its development expenditure. (Laxmi Kant-P.362). The constitution has provisions for borrowing by Indian states which enable them to borrow on security of consolidated fund. Article 292 authorized the union govt. to do so, placed no territorial limitations. While the states could also borrow upon the security of their consolidated fund, Article 293 provides, they could do so only within territory of India.

These are the financial resources for the states from which the states earn revenue. Despite that the financial position of the states are not viable and they have borrowed heavily against the security off their consolidated fund. The current financial position of states is elaborated in succeeding paras.

Financial Position of States

The financial position of Indian states is analyzed in following paras:

States' outstanding public debt increases from 19.1% of GDP in 2018-19 to 25.1% in 2021-22 (PRS-2022). Outstanding public debt of a state comprises liabilities contracted against the consolidated fund of the state and represents the accumulation of borrowing to fund the budget deficit. It includes borrowings from markets and financial institutions, and loans from the central government. At the end of 2021-22, aggregate public debt of states is estimated to be 25.1% of GDP, a significant rise from 17.2% of GDP in 2011-12. This will require states to set aside a comparatively higher percentage of their budget towards interest payments and debt repayment in future, constraining other developmental expenditure. Note that public debt does not include other liabilities of states such as liabilities on public account, which have ranged between 6.7%-7.7% of GDP during 2011-21.

Between 2011-12 and 2014-15, outstanding public debt of states had reduced from 17.2% of GDP in 2011-12 to 16.6% of GDP in 2014-15. Takeover of debt of state-owned power distribution companies under the UDAY scheme was one of the principal reasons for rise in the public debt level in 2015-16 and 2016-17. Due to economic slowdown in 2019-20 and advent of COVID-19 pandemic and associated lockdown in 2020-21, there was an increased dependence on borrowings to fund the expenditure. In 2020-21 and 2021-22, states have been permitted to incur fiscal deficit up to 5% and 4% of their GSDP, respectively (the pre-pandemic limit was 3%).

Among larger states, Assam, Chhattisgarh, Karnataka, and Andhra Pradesh are estimated to register a comparatively higher increase in their outstanding public debt since 2018-19. RBI (2019) had observed that the debt level of a state is considered sustainable if interest payment is less than 10% of its revenue receipt. In 2021-22, states on aggregate are estimated to spend 12.8% of their revenue receipts on interest payment. In 2021-22, 16 states have estimated their interest payment to be higher than the recommended level of 10%.Punjab estimated to have the highest outstanding public debt as % of GDP as of 2021-22.Haryanaestimated to spend the highest proportion of revenue on interest payments in 2021-22.

Note: GST compensation loans given by the Centre to states (which states are not required to repay) have been excluded from public debt.

Sources: State Budget Documents; PRS.

Revenue deficit is the excess of revenue expenditure over revenue receipts. A revenue deficit means that states need to borrow to meet expenses which do not create any assets. A revenue surplus can be used to incur capital outlay or pay off outstanding debt. While a high revenue surplus in the short term may allow for greater spending on asset creation, such a surplus for a longer-term may indicate inadequate revenue expenditure by the state. The 13th Finance Commission (FC) recommended that a long term and permanent target for states should be to maintain a zero-revenue deficit. The 15th FC has provided grants to 17 states in 2021-22 for eliminating revenue deficit. Even after accounting for this grant, 12 states are estimated to observe a revenue deficit in 2021-22. States with notably high revenue deficit in 2021-22 include Haryana (3.3% of GSDP), Tamil Nadu (2.7%), and Rajasthan (2%). Revenue deficit of states on aggregate is estimated to be 0.4% of GSDP in 2021-22.

Fiscal Deficit of States Estimated to be 3.4% of GSDP in 2021-22

Fiscal deficit is the excess of government expenditure over its receipts. A high fiscal deficit of a government implies a higher borrowing requirement in a financial year. The borrowed funds may be spent by the state for various purposes, such as capital outlay and administrative expenditure. For 2021-22, the fiscal deficit limit permitted for states is 4% of GSDP. States will be allowed additional borrowing worth 0.5% of GSDP upon completing power sector reforms. Fiscal deficit of states on aggregate is estimated to be 3.4% of their GSDP in 2021-22. 19 states have estimated their fiscal deficit to be below the 4% level. States with relatively high fiscal deficit in 2021-22 include Chhattisgarh, Madhya Pradesh, and Himachal Pradesh.

States with High Reliance on GST Compensation May Face a Shortfall in Revenue After 2022

GST changed the principle of indirect taxation for many goods and services from origin-based to destination-based. This means that the ability to tax goods and services and raise revenue shifted from the origin state (where goods or services are produced) to the destination state (where they are consumed). This change posed a risk of revenue uncertainty for some states. This concern was addressed by guaranteeing states a 14% compounded annual growth in their GST revenue for a period of five years (i.e., till June 2022). Any shortfall in a state's GST revenue from this level is covered by the Centre by providing compensation grants to the state. For example, if a state's base revenue is Rs 100 in a year, it is entitled to a guaranteed revenue of Rs 114 next year. If the state is unable to earn Rs 114 through its own GST revenue, the Centre provides it compensation to meet the revenue gap.

During 2018-21, most states have relied on compensation grants to achieve the guaranteed revenue, i.e., a 14% annual growth in their GST revenue. In 2018-19, states were able to achieve 88% of the target on their own and relied on compensation for only 12%. The revenue gap has increased since then and states have relied on compensation for 23% of their guaranteed revenue in 2019-20 and 36% in 2020-21. States such as Himachal Pradesh, Punjab, and Uttarakhand have a significantly higher reliance on compensation as compared to the other states.

Due to the compensation guarantee, all states achieved at least a 14% annual growth in their GST revenue. However, once the guarantee ends in 2022, states dependent on GST compensation may get sharply impacted. For example, a significant part of Punjab's guaranteed revenue was met using compensation (37% in 2018-19, 47% in 2019-20, and 56% in 2020-21). After 2022, it will have to increase its own revenue significantly to attain the level of guaranteed revenue achieved so far.

Centre's Preference to Raise Money through Cess and Surcharge Reduces Tax Devolution to States

The Centre's cess and surcharge revenue, which is not shared with states, is estimated to increase by 77% to Rs 4.5 lakh crore in 2020-21; two-thirds of it to come from petrol and diesel. Due to cesses and surcharges, states' share in the Centre's gross tax revenue is around 29% in 2020-21. This is lower than the 41% share in central taxes recommended by the 15th Finance Commission. Share of untied funds in central transfers to states to reduce during 2021-26.

As per the 15th Finance Commission estimates, untied funds (tax devolution + revenue deficit grants) in central transfers are estimated to be 29.5% of the Centre's gross revenue receipts during 2021-26. This is notably less than the same during 2015-20 (32.4%). Due to the declining share of states in the Centre's gross tax revenue, the share of tax devolution is estimated to decline in the central transfers.

Overall Picture of Indian Economy

The 15th Finance Commission estimates the total government debt (the Centre and states) to increase from 70% of GDP in 2018-19 to 90% of GDP by 2020-21. States' outstanding public debt is estimated to increase from 19.1% of GDP in 2018-19 to 25% by 2020-21.

MEASURES NEEDED TO CURB THE MENACE.

Overhaul of FRBM Framework

In view of contemporary challenges, the FRBM framework needs a major restructuring. A high-powered inter-governmental group should be formed to review the FRBM Acts recommend a new FRBM framework for both the Centre and states, and oversee its implementation.

Reporting of Liabilities

States should amend their fiscal responsibility legislation to ensure consistency with the Centre's legislation, in particular, with the definition of debt. A complete reporting mechanism of explicit and implicit guarantee is not yet in place. Standards should be developed for reporting and disclosure of broader public debt and contingent liabilities, and their risks.

Independent Fiscal Council

An independent Fiscal Council should be established with powers to assess records from the Centre as well as states. The Council should only have an advisory role. Some key functions of the proposed council could be: (i) providing multi-year macroeconomic and fiscal forecasts, (ii) assessing the consistency of fiscal targets in states, (iii) carrying out independent assessment of long-term sustainability, and (iv) advising on the conditions for escape clause under FRBM laws.

A Legal Framework for Public Financial Management

A legal framework should be adopted for public financial management providing for fiscal responsibility principles, accounting and reporting, and accountability of government agencies and undertakings.

"Kautilya" the renowned Indian philosopher and economist remarked that "all undertakings depend upon finance, hence foremost attention should be paid to the treasury" seems to be more relevant today.

Conclusion

The significance of sound financial system is too obvious to need any elaboration as no organization can exist, much less achieve its objective, without at least of financial resources. It is concluded that constitution of India has divided financial resources of the country between Centre and states. Sound and efficient financial administration is essential for maintain fiscal targets and avoid Srilanka type crisis. Both the levels of government should adopt austerity measures and avoid any offering of freebies in election manifesto. Each government should understand its responsibilityand tread the path of fiscal discipline.

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