Budget 2023: Expect the Centre to address fiscal stress faced by states

There is increasing recognition for state finances in the post-COVID fiscal strategy in India due to the mounting fiscal risks confronting state governments. The low revenue buoyancy coupled with the rising revenue expenditure, in particular, the subsidy burden post-pandemic and the power sector crisis have put the state finances in the doldrums. An apprehension if the Sri Lankan crisis will be replicated in the Indian states is mounting in policy circles due to high debt and deficits. The debate on non-merit freebies and the decision to return to the old pension scheme by a few states have further catalysed this fear. Against this backdrop, it is inevitable that the Union budget 2023 will hold an articulation for the state finances.

The Union government is also under the grip of high public debt and deficits. In times of geopolitical uncertainties, high debt and deficits are substantiated by strengthening capital infrastructure investment which is inevitable to crowd in private corporate investment.

In the last Union budget, an interest-free fiscal transfer of Rs 1 lakh crore was devolved to state governments for capital infrastructure investment. As states are doing the heavy lifting post-pandemic to enhance public investment, we do expect a hike in the capex transfers to the states in the upcoming Union budget. This capex fiscal transfer decision by the Union government is laudable and it will help in the economic growth recovery process.

States Are Not Like Sri Lanka

High debt and deficits at the subnational governments in India will not trigger a crisis situation like that of Sri Lanka for the prime reason that the financing of deficits is substantially through internal market borrowings in India. Sri Lanka's dependence on external debt was significantly high - including the capital infrastructure projects funded by huge Chinese debt - which culminated in a crisis in its first-ever debt default on May 19, 2022.

The small island economy of Sri Lanka was gripped with setbacks from the disruptions in supply chains, sluggish recovery in contact-intensive sectors like tourism, and the glut in export markets in the plantation sector, textiles, and garments. The slack in remittances also contributed to the crisis. The macroeconomic uncertainties got further aggregated with myopic tax policy decisions to lower the direct and indirect tax rates, which affected the fiscal space. The food inflation spiralled after the structural policies including a total ban on the use of chemical fertilisers, which was done with the intention to cut down fertiliser subsidies.

Yet another important articulation expected from the Union budget 2023 is about an asymmetrical fiscal responsibility and budget management (FRBM) legislation. The fiscal rules envisage a 3 percent fiscal deficit to GDP ratio. Yet, on average, this ratio remained below 3 percent for the state level, on an aggregate analysis. However, the RBI State Finances data showed that the fiscal deficit to GSDP ratio of Kerala (4.1), West Bengal (3.5), Punjab (4.6), Rajasthan (5.2), Uttar Pradesh (4.3), Andhra Pradesh (3.2), Tamil Nadu (3.8) and Telangana (3.9) remained above 3 percent.

As of now, the fiscal rules are symmetrical for Union and state governments at a 3 percent fiscal deficit-GDP ratio. However, the asymmetry in the revenue and expenditure assignments and the subsequent vertical imbalances in the fiscal federal structure, an asymmetry in fiscal rules is warranted. We do expect an announcement related to asymmetric FRBM legislation in the forthcoming Union budget with revised threshold ratios of public debt and deficits to GDP ratio. We hope the forthcoming Finance Bill will carry some articulation about the clauses related to the amended FRBM incorporating this asymmetry in fiscal rules.

High public debt to GSDP ratio above 30 percent was noted for Kerala (37.1), West Bengal (37.1), Punjab (49.1), Rajasthan (40.5), Bihar (38.7), Jharkhand (34.4), Madhya Pradesh (31.9) and Andhra Pradesh (32.8) for FY21, as per the RBI State Finances data for the year 2021-22.

The golden rule of FRBM was to maintain zero revenue deficit to allow the entire borrowings to be utilised for capex investment. However, in most states, the revenue deficit to GSDP remained non-zero and it was as high as 5.5 percent in Bihar and 2.6 percent in Kerala.

The fiscal risk of the states can be captured through high debt and deficit indicators along with the 'interest payment to revenue receipts 'ratio (IP/RR ratio). This ratio reflects how much of the revenue receipts is used for debt servicing. If this ratio is higher, that indicates fiscal risk as it crowds out the fiscal space for developmental expenditure. The states where IP/RR ratio is greater than 15 percent are Haryana (20.9), Kerala (18. 8), Punjab (21.3), Tamil Nadu (21.0), and West Bengal (20.8).

The fiscally stressed states as per all these indicators of high public debt and deficit (fiscal deficit and revenue deficit) along with high IP/RR ratio are Kerala, Punjab, Rajasthan, Bihar, and West Bengal.

Pensions Dilemma

The revival of old pensions in a few states including Rajasthan and Chhattisgarh is also a matter of concern as pensions constitute on average 12 percent of the revenue expenditure for the years between FY18 and FY22. We do believe that the revival of the old pension system within the existing fiscal space against the backdrop of macroeconomic uncertainties is a recipe for deep fiscal vulnerability. The post-pandemic constrained fiscal space can hardly accommodate such unsustainable fiscal policy suggestions.

Yet another important area of concern is power sector debt and we do believe that the forthcoming Union budget will throw some light into such structural reforms. Earlier, liquidity infusion was provided for power distribution companies (DISCOMs) in the form of non-SLR bonds. In the last Union budget, an announcement towards privatisation of DISCOMs was made. However, even after these measures, the financial and operational efficiency parameters remained weak and there are significant inter-state differentials in minimising the aggregate technical and commercial (AT&C) losses to 15 percent and getting the ACS-ARR gap (the gap between the average cost of supply and average revenue realised) at 0.55 per unit kWh. Continuous budget announcements to recapitalise the power sector can create moral hazard. Therefore, the extra-borrowing powers of 0.5 percent in addition to the 3 percent threshold envisaged for state governments on the basis of power sector restructuring is welcome.

Lekha Chakraborty is Professor and Balamuraly B is a research intern at the National Institute of Public Finance and Policy. Views are personal and do not represent the stand of this publication.