State Governments' Finances

Why in news?

The Reserve Bank of India has studied the state governments' finances.

Where are the GFDs of states headed?

- Due to the Covvid-19 pandemic, the gross fiscal deficits (GFDs) of state governments may **double in 2020-21**.
- In 2020-21, about half of the states have budgeted the GFD to gross state domestic product (GSDP) ratio at or above the 3% threshold.
- But most of these budgets were presented prior to the onset of Covid-19.
- The direction of possible revision is evident from the fact that,
    1. The average for states presenting their budget before the outbreak of the pandemic is 2.4%.
    2. But the average for the balance number of states that made post-outbreak budget presentation is 4.6% of GSDP.
- Thus, states are grappling with the pandemic with **constrained fiscal space**.
- In terms of primary balances, states are in an unfavourable position.

Will the stress on states continue?

- The crisis literature focuses on the operation of the scissor effects: **revenue loss** due to demand slowdown, coupled with **higher expenditure** associated with the pandemic.
- The duration of stress on state finances will be contingent upon factors like tenure of lockdown and risks of renewed waves of infections.
- All of this makes traditional backward-looking tax buoyancy forecasting models unreliable, according to the RBI study on state finances.
- The quality of spending and the credibility of the state budgets will assume critical importance.
- The next few years are going to be challenging for the states.

What will be the impact on states?

- As tax revenues fall faster than GDP when growth is negative, **tax revenues** may be **reduced** for the next few years.
- Pandemic related spending, particularly on health and other support

measures for households and firms may keep these expenditures high.
- This may prolong the 'scissor effect'.
- In addition, states' fiscal position is to be affected by a **surge in contingent liabilities** (guarantees).
- In this environment, state governments may have to face the difficult choice of putting investment projects on hold.
- But, given the multiplier associated with capital spending, this will inevitably entail growth losses in a vicious circle feeding itself.
- If the rising States' indebtedness is not accompanied by acceleration in growth, fiscal sustainability will become the casualty.

What happened during earlier pandemics?

- An event study analysis was done using four pandemic outbreaks in India: 1896 plague, 1918 Spanish flu, 1957 Asian flu and 1974 smallpox.
- This study shows that all episodes were associated with a contraction in GDP, with the 1918 flu registering the sharpest downturn of about 13%.
- Interestingly, the recovery pattern is quite similar.
- There was a **sharp rebound** in the immediate subsequent year because of favourable base effects.
- This was followed by **contraction again**, with the GDP growth rate finally subsiding back to pre-pandemic years in about 3-4 years.
- These severe disease outbreaks have also depressed per capita economic output in the economy, albeit with varied magnitudes.
- However, the **recovery** observed was swift and complete within two years of the outbreak.

What the RBI says about the Kerala model?

- The presence of empowered local governance institutions and community participation helped Kerala in effectively reaching out to affected people.
- With the resurgence in new cases, Kerala is actively roping in the services of local self-governments (LSGs) in its fight against the pandemic.
- LSGs have emerged as frontline institutions in containing the disease and in alleviating the distress caused to the vulnerable.
- The state managed to contain the spread of the pandemic in the first wave of infections.
- However, it witnessed a second wave of infections with the arrival of non-resident Keralites and with the easing of restrictions.

What does the RBI say about the Dharavi model?

- Public-private partnership and community participation played a crucial role

in combating Covid-19 in Dharavi, Asia's largest slum.

- The government tied up with doctors, hospitals, NGOs, private volunteers and elected representatives and civil society organisations.
- A rapid action plan of testing, screening, early detection, contact tracing, timely isolation and putting high-risk contacts in institutional quarantine facilities was followed.
- Community participation, community kitchens and collective solidarity were the key features that helped to contain the spread of the virus.
- Enforcing a strict lockdown and blocking the movement of residents except for essential services controlled the contagion.
- Dharavi has flattened the curve and is worthy of emulation worldwide.

Source: The Indian Express

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