The looming crisis in State finances

What is the issue?

States, which were under pressure even before the pandemic struck, are now facing a fiscal crisis that is bound to drag down the economy

How states perform fiscally in recent years?

Gross Fiscal Deficit

- As per the revised estimates for 2020-21 the Gross Fiscal Deficit of the States during
  1. 2012-17 is 2.7% of GDP
  2. 2017-20 is 2.5% of GDP
  3. 2020-21 rose sharply to 4.7% of GDP.



- Even in the pre-pandemic year 2019-20, the gross fiscal deficit was kept under control through a reduction in expenditures, as revenue growth at the level of the states had turned sluggish.
- However the pandemic has reduced revenues and increased expenditures leading to sharp increase in Gross Fiscal Deficit (4.7% in 2020-21).
- This has resulted in a significant increase in deficit financed spending at the State level.

  Deficit financing refers to the methods governments use to finance their budget deficits such as issuing bonds or printing more money.

- With recovery from the pandemic proving to be anaemic, its effects on revenues are likely to be felt in 2021-22 as well.
- But enhancing deficit financed spending may not be an option.

Total Revenue of 31 States and UT -

- Total revenue as per actual estimates in
  - 2017-18 - ₹23.21 lakh crore
  - 2018-19 - ₹26.20 lakh crore
- It was projected to rise to ₹31.54 lakh crore in the State budgets for 2019-20 (Chart 2).
- In practice revenue receipts in 2019-20 stagnated and stood at ₹26.70 lakh crore
- **A Fall In Vertical Devolution -** This is largely because of the reduction in transfer of shareable taxes from the Centre to the States (₹7.47 lakh crore to ₹6.51 lakh crore).
- **Effect of GST regime -** The pandemic and poor collections from the GST regime resulted in reduction of tax revenues accruing to the States even though states' own tax revenues rose marginally (₹18.7 lakh crore to ₹18.3 lakh crore (Chart 3)).
- **Increase in Grant in Aid -** This decline did not reflect in total revenue receipts because of an increase in Grants-in-Aid from ₹5.35 lakh crore to ₹7.48 lakh crore.

- Part of this increase was because of the compensation for shortfall in GST revenues financed by receipts from the cess imposed for the purpose.



- However, the **Centre refused to cover the shortfall in GST revenues relative to a 14% growth trajectory** starting 2015-16 with grants, as originally promised.



What was the reason?

- This deceleration in growth in receipts and spending prior to the pandemic was the result of a slowdown in growth
- The devastating effect of the pandemic and the brutal lockdowns imposed by the government was superimposed on this decelerating trend.

How did the government manage the situation?

- Part of it was covered with borrowing, transferred as back-to-back loans to the States.
- **Compensation through back-to-back loans** amounted to ₹1.1 lakh crore in 2020-21.
- **Compensation through grants** financed by the cess was a lower ₹91,000 crore. This contributed to the spike in the revenue deficit of the States.
- Large **tax concessions were offered to the corporate sector** in September 2019 to revive investment.

Why these measures did not work?

- That had little effect since the deceleration in growth was the **consequence of a demand recession** that called for enhanced spending and not tax giveaways.
- Investment did not revive and net direct tax collections, or gross direct taxes also declined.
- That adversely impacted the volume of taxes transferred to States.

Reference

1. https://www.thehindubusinessline.com/opinion/columns/c-p-chandrasekhar/the-looming-crisis-in-state-finances/article37946483.ece

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