State Tax Revenues

What is the issue?

- There are growing concerns that the two major sources of tax revenues for state governments are likely to fall short of their budget estimates for 2019-20.
- Those sources are State Goods and Services Tax (SGST) and central tax devolution.

What would be its impacts?

- This may result in large fiscal slippages or cutbacks in expenditure at the state level towards the end of the financial year 2019-20.
- The latter is a risk for the economic growth outlook of India and for the liquidity position of corporate that are engaged in state level projects.
- Tax revenues earned by state governments - Own tax revenues (now dominated by SGST) and Devolution of central taxes.
- SGST is budgeted to account for over 40% of the states' own tax revenues in FY20.
- Tax devolution to states is governed by the formulae prescribed by Finance Commissions and takes its cue from the actual collections of the central government.

What are the concerns building up related to SGST collections?

- **Substantial discrepancies** are present in the data available from the Rajya Sabha questions and the states' own budget on revenues related to SGST and GST compensation received by them in FY19.
- Analysis - Several states had over-estimated such revenues in their revised estimates for FY19.
- This optimistic forecasting of SGST collections seems to have persisted in the budget estimates for FY20.
- State governments, in aggregate, have estimated their SGST to expand by 11% in FY20 (budget estimates) relative to their FY19 revised estimates.
- However, the growth in headline GST collections was only 5% in the first half of the financial year.
- If the pace of growth of GST revenues doesn't pickup in the second half, SGST collections may trail what states had forecast (Rs 350-400 billion)

- The GST compensation cess collected in FY20 (April to September) has fallen short of the compensation released to the states this year.
- **Many states require compensation** - This is an acute concern as the 5-year compensation period for GST losses will end in 2022.
- At that point, states will have to reset their expenditures in line with their actual SGST collections, unless the compensation period gets extended.
- With the axe unlikely to fall on social sector spending, infrastructure creation at the state level may get compressed.

What are the concerns related to tax devolution?

- As per the recommendations of the 14th Finance Commission (FC), 42% of the shareable central taxes of the central government (tax devolution) are being devolved to states for the period FY16-FY20.
- But, shareable tax collections exclude surcharges and cess collections.
- In effect, the taxes devolved to states are closer to 35% of the gross central tax collections.
- The "provisional actual" given by the Controller General of Accounts indicate that the GoI's tax revenues in FY19 stood at Rs 20.8 trillion, a considerable Rs 1.7 trillion lower than the revised estimates for that year.
- So, the taxes devolved to the states in that year were based on the Centre's estimates of tax collections in revised estimates.
- This suggests that the tax devolution to states was higher than mandated.
- We estimate this excess transfer at around Rs 0.6-0.7 trillion.
- The pace of growth of the Centre's gross tax revenues stood at a subdued 4% during April-August 2019, sharply lower than the target of 18% enshrined in the budget estimates relative to the "provisional actuals".
- The gross tax revenues of the Centre need to expand by 25% in the remainder of this financial year to meet the budget estimates for FY20.
- This appears challenging given the subdued economic outlook as of now.
- In addition, the recently announced corporate tax cut would result in a revenue loss which the government has pegged at Rs 1.45 trillion.
- This would be shared by the Centre and states.
- Based on the shortfalls in central tax collections in FY19 and the estimated gap in FY20, the aggregate tax devolution to states may be Rs.1.5-2 trillion lower in the current year than it was budgeted.

What could be done?

- To avoid a substantial fiscal slippage at the state government level, a **sizeable expenditure reduction** or deferral is likely to be required.
- The borrowing limit set by the central government acts as a constraint to the size of the states' fiscal deficits.

- Some states may cut productive and capital expenditure towards the end of the year which may pose a key risk to the economic growth outlook.
- Such cutbacks in state government spending could have serious impact on liquidity levels of corporate that are engaged in state level projects.
- The **percentage of tax devolution** that the 15th FC recommends for the period FY21-25 - a key factor that will influence state tax revenues.

Source: The Indian Express