Importance of State Government Budgets

Why in News?

- Recently, RBI released its annual study of state-level budgets.

Why State level budgets matter?

- The understanding of state government finances is becoming more and more important.
- That's because of few broad reasons,

1. States now spend one-and-a-half times more than the Union government and,
2. They employ five times more people than the Centre.

- These two trends mean that states have a greater role to play in determining India's GDP than the Centre.
- States are also the bigger employment generators than Centre.
- It is crucial to understand their spending pattern.
- If their combined expenditure contracts from one year to the other, then it will bring down India's GDP.
- Since 2014-15, states have increasingly borrowed money from the market, a trend captured in the fiscal deficit figure.
- In fact, their total borrowing almost rivals the borrowing by the Union government.
- This trend has serious implications on,

1. The interest rates charged in the economy,
2. The availability of funds for the businesses to invest in new factories, and
3. The ability of the private sector to employ new labour.

Why Fiscal Deficit Matters?

- Suppose there is only Rs 100 in the economy that is available in the form of investible savings.
- This money could be borrowed either by,

1. Private businesses (to invest in a new or existing venture) or
2. By the government (to make roads, pay salaries etc.).

- Suppose if,

1. Businesses borrow Rs 50 and
2. the central government borrows Rs 50.

- If however,

1. State governments also start borrowing, say Rs 20,
2. Then private businesses will have only Rs 30 left to borrow.
3. Then this Rs 30 would come at a higher interest rate,
4. It is because the same number of people would be now vying for less money.

- That is why economy observers and businesses fuss over the fiscal deficit number the most.
- States borrowing more raises concerns especially when they borrow to the meet unexpected policy goals such as farm loan waivers.
- Each year's borrowing (or deficit) adds to the total debt.
- Paying back this debt depends on a state's ability to raise revenues.
- If a state, or all the states in aggregate,

  - Find it difficult to raise revenues,
  - a rising mountain of debt, captured in the debt-to-GDP ratio,
  - could start a vicious cycle wherein states end up paying more and more towards interest payments
  - Instead of spending their revenues on creating new assets that provide better education, health and welfare for their residents.

- State government finances have become more important not only for India's GDP growth and job creation but also for its macroeconomic stability.
- That is why, the 14^{th} Finance Commission had mandated prudent levels of both.

1. Fiscal deficit (3% of state GDP) and
2. Debt-to-GDP (25%) that must not be breached.

What RBI found in its study?

- The report has found, except during 2016-17, state governments have regularly met their Fiscal deficit target of 3% of GDP
- This should allay a lot of apprehensions about state-level finances, especially in the wake of,

1. Extensive farm loan waivers that many states announced,
2. UDAY scheme for the power sector which added extra burden as it was put on state budgets,
3. Under UDAY, state governments had to take over the debts of power distribution companies (discoms).

- However, any relief on the fiscal deficit front is of limited value because,

  - Most states ended up meeting the fiscal deficit target not by increasing their revenues,
  - but by reducing their expenditure and increasingly borrowing from the market.

- In 2017-18 the Fiscal deficit for all states had breached the 3% (of GDP) mark.
- In the very next year, states reduced the Fiscal deficit by 109 basis points and brought it down to just 2.4%.
- But the bulk of this cut was achieved by cutting expenditure and that too capital expenditure.
- It hurts the states' capital budget allocation for key social and infrastructure sectors.

What are its impact on National Economy?

- The RBI's report states that the reduction in overall size of state budgets likely worsened the economic slowdown.
- There has been a reduction in the overall size of the state budget in 2017-19.
- This retarding fiscal impulse has coincided with a cyclical downswing in domestic economic activity and may have inadvertently deepened it.
- It is noteworthy that 2017-18 saw India's GDP growth rate decline to 7.2% and it has been declining since.
- Possibly the most worrisome observation by the RBI is that,

1. While states have met their fiscal deficits, the overall level of debt-to-GDP has reached the 25% of GDP prudential mark.

- A slightly stringent criterion as prescribed by the FRBM Review Committee with the revised debt target of 20% will put most of the states above the threshold warns the RBI.
- The trouble is states have found it difficult to raise revenues.
- States' revenue prospects are confronted with,

1. Low tax buoyancies,
2. Shrinking revenue autonomy under the GST framework and
3. Unpredictability associated with transfers of IGST and grants.

- Unrealistic revenue forecasts in budget estimates thereby leave no option for states than expenditure compression in even the most productive and employment-generating heads.

Source: The Indian Express