

In A State Of Deficit

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Jeffrey Sachs & Nirupam Bajpai

The finances of India's state governments is cause for concern. Over the years, the consolidated financial position of the state governments has deteriorated sharply. A fundamental weakness of state finance is the increase in non-developmental expenditure and interest payments as a proportion of revenue receipts. Structural imbalances in the form of large revenue deficits, rising interest burden, distorted patterns of expenditure and slow growing non-tax revenues are major state finance problems.

These have been aggravated in the past few years. Resource constraints in state finances have been accentuated by a stagnant tax to gross domestic product ratio, rising share of non-developmental outlay in total expenditure, large volumes of subsidies, and loss making state enterprises. Another problem for state finances has been rising demand for public services.

Things will worsen once states accept the fifth pay commission report. Slow growth in revenue mobilization poses serious difficulties for states trying to pay for expenditure. But the critical problem in state finances is not only high levels of expenditure, but also increasing distortions in expenditure patterns.

Though the ratio of state expenditure to GDP fell from 17 per cent in 1990-91 to 15.7 in 1997-98, structural weaknesses persist. They can be seen in estimates of revenue and expenditure for 1997-98. The revenue expenditure under non-developmental heads is to rise by 20 per cent over an increase of 14.8 per cent in 1996-97. Interest payments and administrative services account for 60 per cent of the total increase in revenue expenditure in 1997-98. Thanks to such inflexibility, revenue expenditure has increased from an average 11.3 per cent of GDP during the late Nineties to over 12.5 per cent in 1997-98.

Further, states' tax revenue as a proportion of GDP will remain stagnant at the 5.7 per cent level of the late Eighties. But states' non-tax revenue will decline to 1.6 per cent of GDP in 1997-98 from the low level of 1.9 per cent in 1996-97 due mainly to increased implicit subsidies and low if not negative rates of return in state level public enterprises.

The states' 1997-98 consolidated fiscal deficit is estimated at 2.9 per cent of GDP. Of this, 51.3 per cent was financed via loans from the Centre, the remainder through states' market borrowings and capital receipts. Loans from Centre to state constitute an expenditure item in the Centre's budget. But they constitute a financing source for states' fiscal deficit. The impact of states' fiscal deficit on the combined fiscal deficit of Centre and states is a significant issue relating to state finances.

State governments' revenue deficits have been rising since 1987-88. Large and persistent revenue deficits have implied diversion of high cost borrowing for consumption purposes, leading to less investment expenditure. The investment outlays of states as a ratio of GDP have declined from 2.8

per cent in 1990-91 to 2.2 percent in 1997-98. An expenditure pattern like this means far less money for infrastructure and capital asset maintenance.

Aggregate states' revenue deficit was placed at Rs 156 billion in 1996-97 or 1.2 per cent of GDP. The figure for 1997-98 is slightly lower at Rs 125 billion or 0.9 per cent of GDP. The states' fiscal deficit is primarily because of five states: Uttar Pradesh, Tamil Nadu, West Bengal, Andhra Pradesh and Kerala. They account for 85.6 per cent of the consolidated states' revenue deficit. A high proportion of this is caused by revenue deficits for the states of Uttar Pradesh - 69.8 per cent, Kerala - 51.9 percent, Tamil Nadu - 49.8 per cent, Punjab - 45.1 per cent, and West Bengal - 42.3 per cent. In these states, a large chunk of borrowings is preempted to finance current expenditure. This shrinks resources available for development capital outlay.

The states' debt burden in relation to GDP has remained steady at 20 per cent. But interest payment burden has risen steadily from an average 11 per cent in the late Eighties. It is likely to reach 17.7 per cent in 1997-98. This increase is partly because of market borrowings by the states and reduced interest subsidies on Central loans. But the downward rigidity in the state debt to GDP ratio has precluded any offsetting adjustment in incremental debt to contain the interest burden.

A shift towards changing the pattern of resource allocation and improving the resource base of states is critical to improving state finances. While reforms like introducing state level value added tax have begun, they have to be implemented in all states to enhance the revenue productivity of the state tax system and reduce its distortionary implications for the economy.

Any state level expenditure adjustment must take into account critical social services. State social service expenditure rose from 4.8 per cent of GDP in 1980-81 to 5.6 in 1990-91. In the late Nineties there was a decline in the ratio owing to the resource crunch faced by a number of states. It came down to 5.3 per cent in 1992-93, 5.1 in 1994-95 and then remained in the range of 5.1 to 5.5 percent.

Much social service expenditure goes to education. Education expenditure was 2.3 per cent of GDP in 1980-81, rose to three per cent in 1990-91, came down to 2.9 in 1995-96 and remained stagnant thereafter. Expenditure on public health and family welfare declined through the Eighties and early Nineties. It was 1.2 per cent of GDP in 1980-81, fell to 0.9 in 1990-91 and has stayed below one per cent.

Human resource development is essential to all round development of economy. The outlay on social services should be increased and proper end use ensured. Given the deteriorating states' fiscal situation, improving social sector expenditure would mean recovering a reasonable part of the cost and raising additional resources to finance these expenditures. A viable public expenditure policy would also need to be pursued, taking into account the explicit and implicit subsidy burden on state finances, and their implied distributional impact. Subsidies need to be targeted to the really needy. And a system of properly priced public utilities should go together with redistributive policies that improve the states' resource base.

A Central discussion paper in May 1997 provides a comprehensive estimate of explicit and implicit government subsidies. Total subsidies given by Central and state governments was Rs 1,373 billion

during 1994-95, 14.4 per cent of GDP - Rs 430 billion from the Centre, Rs 942 billion from the states. Central and state subsidies on non-merit goods and services (like irrigation, power, industries, transport and so on) amounted to 10.7 per cent of GDP. The average national recovery rate for non-merit goods and services was 10.3 per cent in 1994-95; the Centre's recovery rate being slightly higher at 12.1 per cent than the states' 9.3 per cent.

The papers suggested reforms to reduce the overall scale of subsidies, was to make them more transparent, use them for well defined economic objectives, focus on final services and goods to maximize impact on target populations, institute periodic reviews and set limits on the duration of schemes. The existing subsidy rate for non-merit goods and services for both Centre and state is 90 per cent of cost. Reducing this to 50 per cent could reduce subsidies - on non-merit goods and services to six per cent of GDP and cut the combined fiscal deficit of Centre and state from 6.5 per cent of GDP in 1996-97 to less than two per cent. The key to subsidy reduction lies in phased increases in user charges in power, transport and so on.

To step up infrastructure investment states have to undertake policy reforms so as to attract a high order of private sector participation. Infrastructure constraints can only be overcome if the Centre creates a regulatory and economic environment conducive to large inflows of foreign investment. Most importantly, the Centre needs to empower the states to negotiate infrastructure projects with prospective foreign investors according to basic norms, but without the Centre's long and cumbersome approval procedures. While the United Front government began empowering state governments in this regard, there is still a long way to go.

Responding to the emerging fiscal challenges, some states have initiated long term structural reforms of their finances in order to broaden the tax base and redress the imbalances in their expenditure patterns. These reforms have yet to significantly improve states' finances since they have been partially implemented and move slowly. Some states - like Kerala, Maharashtra, Rajasthan, Punjab and Uttar Pradesh - have reformed their sales tax system and simplified their administrative structure to mobilize higher levels of revenue. Tamil Nadu, Karnataka, Himachal Pradesh, Goa, Haryana, Kerala and Orissa have encouraged private sector participation in the transport and power sectors.

Some states have also granted some autonomy to the power sector by setting up an independent state electricity regulatory commission. Maharashtra, Rajasthan and Punjab have privatized octroi collection. A more efficient tax system based on value added taxation rather than turnover taxes, inefficient trade taxes like octroi could raise revenues while lowering effective tax rates. Against a backdrop of deteriorating financial positions, the budget estimates of states for 1997-98 reflect corrective efforts by some governments. There has been some scaling down, in nominal terms, of major deficit indicators like the consolidated revenue deficit and a step up in direct capital outlay.