State Finances: A Study of Budgets

written by iasexam.com | 23/01/2023

Context- Reserve Bank of India has recently released its report 'State Finances: A Study of Budgets' on state government budgets for 2022-23.

Key Highlights

- The study is an annual report by the Reserve Bank of India which provides data and analysis of the fiscal position of State governments in India.
- The report examines the role and impact of capital outlay of State governments in India and the challenges they have to confront in this regard with the theme 'Capital Formation in India – The Role of States'.
- Capital formation indicates to the process by which resources are invested in assets like plants, equipment, machinery, transportation assets, electricity and other physical assets as well as in human capital through education, health, skill development, scientific advancement, and research.
- These investments increase the economy's productive capacity, ensure fuller absorption of unutilized labour and other natural resources, and also promote efficiency raising innovation.

The salient findings of the report

- The fiscal health of the States has improved from a sharp pandemic-induced deterioration in 2020-21 because of economic recovery and resulting high revenue collections.
- States' gross fiscal deficit (GFD) is budgeted to reduce from 4.1 per cent of gross

domestic product (GDP) in 2020-21 to 3.4 per cent in 2022-23.
- States' revenue collections declined in 2020-21 on account of the pandemic-induced slump in own tax revenue, non-tax revenue as well as tax devolution from the Centre.
- For 2021-22, States budgeted a sharp growth in revenue receipts led by own tax and non-tax revenues and grants from the Centre.
- States have budgeted for increased revenue receipts in 2022-23, driven primarily by SGST, excise duties, and sales tax collections.
- States' revenue expenditure had grown sharply in 2020-21, reflecting the response to the COVID-19 pandemic.
- The revenue expenditure of States raised by 20.7 percent in 2021-22 (RE), mainly on account of increase in developmental spending on medical and public health, water supply and sanitation and social security and welfare.
- For 2022-23, States have budgeted a growth in revenue spending, mainly led by non-developmental expenditure such as pension and administrative services.
- States' capital outlay recorded a robust growth of 31.7 per cent in 2021-22, partly supported by the Centre's budgetary allocation for States under the 'Scheme for Financial Assistance to the States for Capital Investment', providing the required support to the recovering economy.
- In 2022-23, they have budgeted for an increase in capital outlay by 38.4 percent.
- The state debt-to-GDP ratio remains higher. The debt-to-GDP ratio has declined from 31.1 per cent in 2020-21 – a year when states had struggled to manage the economic fallout of the pandemic — to 29.5 per cent in 2022-23.
- It is still higher than 20 per cent as recommended by FRBM Review Committee, 2018.
- Punjab, Tamil Nadu, Haryana and West Bengal have the highest interest payments to revenue receipts ratio.
- It implies that in these states, interest payments account for a sizable portion of the states' revenues, leaving them with less room to spend on other areas of priority such as health or education.
- State governments have seen a significant expansion in their contingent liabilities.
- Contingent liabilities here indicate the obligations of a state government to repay the principal and interest payments in case a state-owned entity defaults on a loan.
- Lastly, new risks have emerged with some states now choosing to return to the old pension scheme.
- In the early 2000s, there was a growing realisation that financing the old pension scheme would prove to be challenging.
- Shifting back to the old pension scheme will only end up rising pension liabilities, leaving even less room for more productive spending.

Recommendations

- State governments can promote investment through both direct as well as indirect channels.
- The direct channel involves spending on physical infrastructure and on human capital.
- The indirect channels act by crowding in private investment, promoting good governance, and also attracting foreign direct investment (FDI).
- In 2022-23, States have budgeted higher capital outlay than in 2019-20, 2020-21 and 2021-22. Going forward, higher allocations for sectors like health, education,

infrastructure and green energy transition can help expand productive capacities.

- It is also worthwhile to consider creating a capex buffer fund during good times when revenue flows are strong so as to smoothen and maintain expenditure quality and flows through the economic cycle.
- To crowd in private investment, the State governments may continue to focus on creating a congenial ecosystem for the private sector in order to thrive.
- States need to encourage and facilitate higher inter-state trade and businesses to realise the full benefit of spillover effects of State capex across the country.