



State Government Finances: Fiscal Federalism, Rising State Debt and the Need for Structural Reforms

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Recent Developments:

- **Kerala and Tamil Nadu** have recently released **White Papers** highlighting rising outstanding debt, increasing committed expenditure and shrinking fiscal space for development, reviving the debate on the sustainability of **State finances** in India.
- Recent **CAG State Finance Reports** have also flagged persistent fiscal imbalances, high committed expenditure and increasing dependence on borrowings in several States.

Fiscal Federalism and the Core Fiscal Dilemma:

Structural Imbalance in Indian Fiscal Federalism:

- **Fiscal deficit** arises when a government's total expenditure exceeds its revenue receipts excluding borrowings.
- India's fiscal structure creates a **vertical fiscal imbalance**, where the **Union Government possesses greater taxation powers**, while **States undertake a larger share of developmental expenditure**.
- States bear primary responsibility for delivering essential public services despite having comparatively limited revenue-raising capacity.
- This structural mismatch compels many States to rely on market borrowings to finance developmental commitments.

Major Expenditure Responsibilities of States:

- **Social sectors: Health, education, nutrition, social welfare** and human development programmes.
- **Economic sectors: Agriculture, irrigation, rural development, transport, power** and local infrastructure.
- States also finance salaries of teachers, healthcare workers, police personnel and numerous frontline public servants.

Sources of State Finances:

Own Revenue Sources:

- **State GST (SGST)** constitutes the largest component of States' own tax revenue.
- Other sources include **State excise duty, stamp duty, registration fees, motor vehicle tax** and non-tax revenue.

Transfers from the Union Government:

- **Tax devolution** recommended by the **Finance Commission**.
- **Grants-in-aid** under Article **275** and other statutory provisions.
- **Centrally Sponsored Scheme (CSS)** assistance.

- Loans and other fiscal support from the Union Government.

Why Revenue Still Falls Short:

- Even fiscally efficient States may receive a relatively smaller share of Union tax devolution because Finance Commission transfers are based on multiple criteria such as **income distance, population, forest cover, demographic performance and tax effort**.
- Consequently, expenditure obligations often grow faster than available revenues, widening fiscal deficits.

Kerala as a Case Study:

Revenue Strength but Limited Fiscal Space:

- Kerala records one of the strongest **own tax revenue performances** among Indian States.
- Despite strong tax mobilisation, its share in Union tax devolution remains relatively modest compared to its developmental responsibilities.
- The revenue gap is therefore financed largely through **State borrowings**, increasing future interest obligations.

Pattern of Public Expenditure:

- A substantial share of State expenditure is committed towards:
- **Salaries, pensions and interest payments**, leaving limited fiscal space for new investments.
- Only a relatively small portion of the budget remains available for **capital expenditure**, which creates productive public assets such as roads, transport systems and educational infrastructure.

The Investment Dilemma:

- Reducing expenditure on salaries or pensions may weaken public service delivery and social sector achievements.
- Maintaining current expenditure, however, leaves insufficient resources for future-oriented investments.
- Limited capital formation constrains employment generation, industrial competitiveness and long-term economic growth.
- Fiscal stress has also contributed to migration of skilled youth seeking better employment opportunities outside the State.

Understanding State Debt:

Why State Debt Should Not Be Viewed Uniformly:

- Public debt becomes problematic primarily when borrowings finance persistent consumption without improving future productive capacity.
- Borrowing for **infrastructure, education, healthcare, research and productive public investment** can strengthen long-term economic growth and future revenue generation.
- Therefore, the quality and utilisation of debt are often more important than the absolute size of debt.

How States Borrow:

- States primarily raise funds through **State Development Loans (SDLs)** issued in the domestic bond market.
- Domestic investors such as **banks, insurance companies and financial institutions** purchase these securities using household savings.
- Thus, State borrowing largely mobilises domestic savings for public investment.

India and China's Subnational Financing Model:

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China's Approach:

- Provincial and local governments undertake a large share of infrastructure-led development.
- Financing sources include:
 - **Local Government Bonds (LGBs),**
 - **Land sale revenues,**
 - **Local Government Financing Vehicles (LGFVs),**
- Central fiscal transfers.
- Strong coordination between central planning and local investment supports long-term growth.

India's Constraints:

- Indian States borrow mainly through **SDLs**, generally at higher interest rates than the Union Government.
- Higher borrowing costs increase debt servicing burdens and reduce resources available for developmental expenditure.
- Borrowing ceilings imposed under fiscal responsibility frameworks further restrict investment capacity.

Challenges in State Finances:

Major Fiscal Challenges:

- **High committed expenditure** crowds out productive capital investment.
- **Rising interest payments** reduce fiscal flexibility.
- Limited taxation powers constrain independent revenue generation.
- Increasing dependence on borrowings creates long-term fiscal liabilities.
- Higher borrowing costs compared to the Union Government raise debt servicing burdens.
- Fiscal stress may weaken infrastructure creation and employment generation.

Way Forward:

Strengthening Fiscal Federalism:

- Enhance predictability and transparency in **Union-State fiscal transfers**.
- Rationalise borrowing limits based on the quality of public investment rather than uniform ceilings.
- Expand fiscal space for well-designed capital expenditure.
- Improve efficiency of public expenditure through outcome-based budgeting.
- Strengthen States' capacity to mobilise own tax revenue and improve tax administration.
- Encourage cooperative fiscal federalism through greater Centre-State coordination.
- Improve debt transparency, medium-term fiscal planning and independent fiscal monitoring.

Constitutional & Institutional Provisions:

Important Constitutional Articles:

- **Article 268–281:** Distribution of financial resources between the Union and States.
- **Article 280:** Establishment of the **Finance Commission**.
- **Article 293:** Borrowing powers of State Governments.
- **Article 275:** Grants-in-aid to States.

Important Institutions:

- **Finance Commission**
- **Reserve Bank of India (RBI)**
- **Comptroller and Auditor General (CAG)**

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- **GST Council**

Value Addition for UPSC:

Important Terms:

- **Fiscal Deficit:** Excess of total expenditure over total receipts excluding borrowings.
- **Revenue Expenditure:** Expenditure incurred for day-to-day administration and service delivery without creating assets.
- **Capital Expenditure:** Expenditure that creates durable public assets or enhances productive capacity.
- **Committed Expenditure:** Mandatory expenditure on **salaries, pensions and interest payments**.
- **State Development Loans (SDLs):** Market securities issued by State Governments to raise funds.
- **Vertical Fiscal Imbalance:** Mismatch between taxation powers and expenditure responsibilities across different levels of government.
- **Cooperative Fiscal Federalism:** Collaborative financial coordination between the Union and States to ensure balanced development