

# press release

## **GST implementation may hold positive surprises for States' Finance: Standard Chartered special report**

**Mumbai, May 30, 2017:** GST implementation may hold positive surprises for states' finances and as per the initial calculation, the states can look at a total gain of INR 350-450bn (0.2-0.3% of GDP). According to **Standard Chartered Bank's special report *India – States' Finances: The other half of the story***; this should easily help absorb most of the additional strain on fiscal deficits. If states can keep their fiscal deficits within the budgeted target (2.7%) and the central government adheres to its target of 3.2% of GDP, the combined FY18 deficit could be 6% (or lower) – the narrowest since FY08.

The study has assessed the underlying dynamics of various states' finances over a decade and identified the consistent outperformers / underperformers. Together, the 18 states in the sample (the study has considered Andhra Pradesh and Telangana jointly, as the splitting of the state in 2014 creates accounting issues in analysing them separately) account for 90% of all states' gross state domestic product (GSDP), fiscal deficits, revenue and expenditure.

The broad conclusions of the study are highlighted below:

**Finances deteriorate but remain in check:** Higher capital expenditure and a slower pace of own-tax revenue collection have led to wider fiscal deficits for states since FY13. This has more than offset the benefits of states' increased share of central government taxes from FY16. The study estimates that the states' FY17 fiscal deficit was 2.7% of GDP, much wider than 2.0% in FY13 but well below the 3% target mandated by the Fiscal Responsibility and Budget Management (FRBM) Act. Factoring in UDAY bond issuance, states' aggregate fiscal deficits in FY16 and FY17 (revised estimates) were 3.2% and 3.6% of GDP, similar to 3.5% for the central government in FY17. This appears to be a breach of the FRBM Act. However, State Electricity Boards' (SEBs') debt has been an off-budget liability for states. Its inclusion in states' fiscal deficit calculation is therefore not a fresh liability. As a result, the study has observed that this is as an optical rather than an actual breach.

**GST implementation could provide a positive surprise for states' finances:** The findings estimate that the 18 states tracked in aggregate aim to keep their FY18 fiscal deficit unchanged from FY17 at 2.7% of GDP (excluding UDAY impact). It is estimated that the risk of slippage is limited to 0.1% of GDP, given that: (1) additional interest payments on UDAY bond issuance have been partially budgeted for; (2) most states are still assessing Pay Commission recommendations, with the exception of one that has announced firm dates for salary increases; and (3) the additional expenditure burden of farm-loan waivers for most states (apart from Uttar Pradesh) is likely to be small. The report points out that it expects limited risk of slippage unless several states unexpectedly implement salary increases mid-year. Hence, the additional strain on fiscal deficits can be easily absorbed, as impending GST implementation in mid-2017 should mean higher revenues for all states. The central government has agreed to compensate states for any revenue loss for five years after GST implementation.

**Broad adherence to rules masks wide divergence:** Notwithstanding broad adherence to fiscal consolidation rules at the aggregate level, fiscal performance diverges significantly among states. During FY14-FY16; 25% of the 18 states consistently ran fiscal deficits wider than 3% of GSDP, and 55% ran revenue deficits. Fiscal consolidation rules required states to eliminate their revenue deficits by FY15.

While factors such as the states' fiscal health in the initial phase of analysis (FY06-FY10) and their shares of revenue transfers from the central government are important determinants of current fiscal health, each state's political will to achieve fiscal consolidation plays a more important role. The consistent outperformance of states like Karnataka and Chhattisgarh, according to the Fiscal Performance Index, reflects these factors.

Similarly, some states (such as Punjab, West Bengal and Himachal Pradesh) consistently rank lower in the Fiscal Performance Index due to factors such as late adoption of fiscal responsibility rules, high recurrent expenditure and thus high outstanding liabilities.

**State Development Loan (SDL) yields do not reflect divergent fiscal health:** Despite significant differences in the financial strength of states, market pricing of SDL yields shows no corresponding differentiation.

The study observes that there is no relationship between rankings based on states' fiscal performance and their cost of market borrowing. The dispersion of yield levels between states is also narrow. There can be three reasons for this lack of correlation between fiscal health and yields: (1) zero risk weight assigned to SDLs under Basel III capital regulations; (2) states' liquidity buffers; and (3) accounting treatment of banks' SDL holdings.

#### **Summary:**

More policy measures are needed for better fiscal discipline. Various reforms, including potential measures to deepen the SDL market and greater transparency in financial reporting are required. The recently submitted recommendations of the FRBM panel for a more conservative fiscal consolidation plan for both the centre and states should be adopted to ensure better fiscal management and debt reduction.

#### **Note to Editors:**

This report is divided into five sections. The **first section** discusses the broad budget trend for states relative to the central government over the past decade, noting their unique fiscal features. In the **second section**, we analyse the budgets of 18 states in detail (considering Andhra Pradesh and Telangana jointly); we focus on recent years, including budgeted estimates for FY18 amid the impending implementation of GST and rising bond issuance (owing to UDAY and farm-loan waivers). Based on their fiscal trends over the past decade, we rank the 18 states using our Fiscal Performance Index in the **third section**.

In the **fourth section**, we discuss the idiosyncratic features of the SDL market that keep yield dispersion narrow, despite divergent fiscal health among states. In the **final section**, we consider potential measures that we think would deepen this market and are needed to engender fiscal discipline.

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