1. Revenue Deficits and Debt Burdens - Economy

The Ministry of Finance's Monthly Economic Review cautioned that several Indian states with high revenue deficits and heavy debt burdens will struggle to handle fiscal shocks.

1.Background

India's federal fiscal architecture distributes expenditure responsibilities and revenue powers between the Union government and state governments, creating interdependencies requiring coordination for macroeconomic stability. Post-independence decades witnessed centralized fiscal management with states heavily dependent on central transfers, limited own revenue mobilization, and soft budget constraints encouraging fiscal indiscipline. The 1990s liberalization and subsequent Fiscal Responsibility and Budget Management Acts aimed to impose fiscal discipline through deficit targets and debt limits. However, implementation remained uneven—while the Centre gradually consolidated its fiscal position post-2003, many states continued accumulating debt through populist spending, unproductive subsidies, and revenue mobilization failures.

The COVID-19 pandemic dramatically worsened state finances as revenues collapsed from economic lockdowns while expenditures surged for health emergencies, relief measures, and economic support. States borrowed heavily, often exceeding FRBM limits with central permission, pushing debt-to-GSDP ratios to concerning levels. As the economy recovered, structural fiscal weaknesses became apparent—some states like Punjab, Himachal Pradesh, Kerala, West Bengal, Andhra Pradesh, and Rajasthan ran persistent revenue deficits meaning their regular tax revenues couldn't even cover routine expenditures like salaries, pensions, and interest payments, forcing borrowing for day-to-day operations rather than development. This contrasts sharply with revenue-surplus states like Gujarat, Jharkhand, Uttar Pradesh, Telangana, Odisha, Uttarakhand, Bihar, and Goa maintaining fiscal deficits at or below the recommended 3% of GSDP. The Ministry of Finance's caution reflects concern that fiscally stressed states lack buffers to absorb future shocks—whether economic slowdowns, natural disasters, or commodity price volatility—potentially requiring central bailouts that would compromise national fiscal consolidation efforts and intergenerational equity.

2.Understanding Fiscal Concepts

Revenue Deficit

1. Revenue deficit occurs when a government's regular recurring spending including salaries, pensions, subsidies, and interest payments exceeds its regular income from taxes and fees.
2. This indicates the government cannot fund routine operations from its own revenues, requiring borrowing for day-to-day expenses rather than capital investments.
3. Persistent revenue deficits signal fundamental fiscal unsustainability as borrowing finances consumption rather than asset creation.

Revenue Surplus

1. Revenue surplus implies states can meet their revenue expenditure—salaries, pensions, subsidies—through their own tax and non-tax receipts.
2. This reduces reliance on borrowings for day-to-day spending, improving fiscal sustainability and creditworthiness.
3. Surplus revenues can fund capital expenditure creating infrastructure and productive assets benefiting future generations.

Fiscal Stress

1. Fiscal stress refers to persistent or temporary mismatch between government revenues and expenditures.
2. This mismatch forces policymakers to make difficult adjustments including spending cuts, revenue increases through taxation, or increased borrowing.
3. Prolonged fiscal stress threatens macroeconomic stability, development priorities, and intergenerational equity.

3.Causes of State-Level Fiscal Stress

Structural Revenue Weaknesses

1. Narrow tax bases concentrate revenue generation on limited economic activities and taxpayer segments.
2. Uneven GST collections reflect varying economic development levels and tax administration capacities across states.
3. Dependence on indirect taxes creates revenue volatility as consumption patterns fluctuate with economic cycles.
4. Agricultural income exemption from taxation removes significant economic activity from the tax base in agrarian states.

Expenditure Rigidities

1. Rising subsidies for food, fertilizers, fuel, electricity, and water create committed expenditures difficult to reduce politically.
2. Welfare commitments including pensions, social security schemes, and populist programs constitute non-discretionary spending.
3. Pay commission implementations and government employment expansion increase salary and pension burdens.
4. These committed expenditures leave limited flexibility for development spending or shock absorption.

Debt Burden Dynamics

1. High accumulated borrowing and associated interest payments crowd out development spending.
2. As debt-to-GSDP ratios rise, increasing proportions of revenue finance past borrowing rather than current services.
3. This creates vicious cycles where borrowing finances interest payments rather than productive investments generating future revenues.

Economic and External Shocks

1. Pandemic-related expenditure surges for health infrastructure, relief measures, and economic support stressed finances.
2. Global commodity price volatility affects subsidy burdens, particularly for fuel and fertilizers.
3. Climate-related disasters including floods, droughts, and cyclones require emergency spending and reconstruction investments.

Compliance and Administrative Gaps

1. Tax evasion and avoidance reduce revenue collections below potential.
2. Weak enforcement mechanisms allow non-compliance to persist without consequences.
3. Underperformance in capital expenditure indicates absorption capacity constraints and implementation failures.

4.Impacts of Fiscal Stress

Rising Debt Burden

1. Fiscal stress increases debt accumulation as governments borrow to finance deficits.
2. Higher interest burdens consume increasing revenue shares, reducing funds available for development spending.
3. Deteriorating fiscal metrics risk credit rating downgrades, increasing borrowing costs and reducing market access.

Reduced Fiscal Space

1. Fiscal stress reduces government flexibility to respond to economic downturns or emergencies.
2. Limited fiscal space constrains investments in infrastructure, education, health, and social sectors critical for development.
3. Development programs face cuts or delays, slowing economic growth and social progress.

Macroeconomic Instability

1. Heavy government borrowing from domestic markets raises interest rates by increasing demand for loanable funds.
2. Higher interest rates restrict private sector investment through crowding out effects.
3. Reduced private investment slows economic growth, employment generation, and productivity improvements.

Weak Social and Development Outcomes

1. Fiscal stress limits spending on health, education, and welfare programs essential for human capital development.
2. Inadequate social spending perpetuates poverty, inequality, and capability deprivation.
3. Regional disparities widen as fiscally stressed states fall further behind in development indicators.

Intergenerational Burden

1. Higher current borrowing shifts repayment obligations to future generations who didn't benefit from borrowed funds.
2. This raises long-term debt sustainability risks, especially if future economic growth slows.
3. Future generations face higher tax burdens or reduced services to service past debts.

5.Fiscal Position of Indian States

Revenue-Surplus States

1. Jharkhand, Uttar Pradesh, Telangana, Gujarat, Odisha, Uttarakhand, Bihar, and Goa maintain revenue surpluses.
2. These states can fund regular expenses including salaries, pensions, and subsidies from own revenues without borrowing.
3. Eight states—Gujarat, Jharkhand, Uttar Pradesh, Telangana, Odisha, Uttarakhand, Bihar, and Goa—maintain fiscal deficits at or below 3% of GSDP.
4. This performance aligns with the Finance Commission's recommended benchmark for fiscal discipline.
5. The 16th Finance Commission chaired by Arvind Panagariya also recommends a 3% fiscal deficit cap for states.

Revenue-Deficit States

1. Punjab, Kerala, West Bengal, Andhra Pradesh, Rajasthan, and Himachal Pradesh run persistent revenue deficits.
2. These states struggle due to high committed spending on pensions, interest payments, salaries, and subsidies.
3. Routine operations require borrowing as own revenues prove insufficient for day-to-day expenses.

Debt Level Variations

1. Punjab is India's most indebted state with debt at 45.1% of GSDP, followed by Himachal Pradesh at 40.5%.
2. Rajasthan and Andhra Pradesh also carry high debt burdens at approximately 36% of GSDP.
3. Odisha and Gujarat maintain relatively low debt levels, indicating stronger fiscal health and management.
4. These variations reflect different fiscal management capabilities, revenue mobilization efforts, and expenditure priorities.

6.Repercussions of Fiscal Divergence

Revenue-Surplus States' Advantages

1. Lower interest payments free up resources for higher capital spending on infrastructure and productive investments.
2. Fiscal flexibility enables quicker responses to economic opportunities and challenges.
3. Better credit ratings reduce borrowing costs when external financing is needed.

4. Stronger fiscal positions attract private investment through better infrastructure and business environments.

Revenue-Deficit States' Constraints

1. Large revenue shares—often exceeding 15% of total revenue receipts—service debt rather than funding development.
2. Higher outstanding debt limits borrowing capacity for capital investments.
3. Fiscal inflexibility prevents adequate responses to economic downturns or natural disasters.
4. Deteriorating fiscal metrics trigger market concerns, raising borrowing costs and reducing access.

Shock Vulnerability

1. States combining revenue deficits with high debt levels have minimal flexibility for shock absorption.
2. Economic slowdowns, natural disasters, or commodity price spikes force difficult choices.
3. Fiscally stressed states often cut or restructure spending, reducing development and welfare programs.
4. Alternatively, they seek additional central financial support creating federal tensions.

Federal Fiscal Tensions

1. Demands for central support arise while the Centre itself pursues fiscal consolidation.
2. Bailouts create moral hazard encouraging continued fiscal indiscipline by states expecting future rescues.
3. Federal disputes arise over revenue sharing, borrowing limits, and fiscal responsibility enforcement.

7.Way Forward

Strengthen Revenue Mobilization

1. Expand tax bases by improving compliance, reducing exemptions, and digitizing tax administration, while enhancing state GST collections through better coordination, technology adoption, and capacity building, ensuring states capture full revenue potential from economic activities within their jurisdictions.

Rationalize Expenditure

1. Review and rationalize subsidy programs ensuring better targeting, eliminating leakages, and focusing on those genuinely needing support, while controlling committed expenditure growth through pension reforms, right-sizing government employment, and performance-based compensation rather than automatic increments.

Invest in Capacity Building

1. Improve state fiscal management capacity through training, technology adoption, and knowledge sharing, while strengthening public financial management systems enabling better budgeting, execution, monitoring, and accountability across revenue and expenditure functions.

Conclusion

High state-level debt reaching 35-45% of GSDP in some cases significantly contributes to India's overall public debt burden. States unable to maintain the "golden rule" of zero revenue deficit face heightened vulnerability to fiscal stress, especially during rising expenditure periods. While eight states including Gujarat, Jharkhand, and Uttar Pradesh maintain fiscal deficits at or below 3% of GSDP, states like Punjab (45.1% debt-to-GSDP), Himachal Pradesh (40.5%), and others struggle with revenue deficits and heavy debt burdens. Maintaining fiscal discipline remains essential for macroeconomic stability and shock management requiring joint consolidation efforts by Centre and States.

Source - https -//www.thehindu.com/business/Economy/states-with-revenue-deficits-high-debt-burdens-will-find-current-crisis-more-challenging-centre-warns/article70923788.ece