Fiscal deficit in 2020-21 to be around 13%

28 September, 2020

Faced with the twin issues of revenue loss and need to incur higher spending due to the pandemic and the resultant lockdown, the finances across all the levels of government have been severely strained. The central as well as state governments have seen a sharp increase in their deficits, requiring them to resort to higher borrowings to bridge the deficit. The centre had already announced an increase in its gross borrowing programme by Rs 4.2 lkh crore while states were given the assurance to increase their fiscal deficit unconditionally by 0.5% of GSDP.

Given the nature of the financial relation between the central and state governments, there is significant dependence of the latter on the former in terms of share in tax revenues and grants received. One such is the GST (Good and Services Tax) implementation compensation to states. The restrictions on the conduct of commercial activity over the last 6 months has led to a sizeable drop in the centre's GST collections. This in turn has led to shortfalls in the compensation payable to states. To address this shortage in revenue, the GST council has proposed 2 options both of which would require the states to borrow through issue of debt that would be serviced partly/fully from the cess that is to be levied on certain luxury and demerit goods for an extended period of time.

Lower revenues from the central government would have implication for the state's fiscal deficit and coupled with the increase in the central government deficits amidst the contraction in economic growth, would significantly push up the country's combined fiscal deficit in the current financial year. It could also result in the state's breaching the 3 % fiscal deficit target prescribed by the Finance Commission as well as the, one time relaxation, of additional 0.5% of unconditional borrowing granted by the central government to states for 2020-21.

To estimate the increase in the combined fiscal deficit, we have made projections of the fiscal deficit of the state governments along with that of the central government. We have also examined the state and central government financial position over the 4-month period Apr-Jul'20 along with the budgets for 2020-21.

State Government Finances in 2020-21: Unanticipated Strain

States have been at the forefront of the control and fight against the pandemic. They have the difficult task of effectively implementing restrictions on the conduct of normal activity while also providing for the proper functioning of the state machinery. With various restrictions that were imposed since mid-Mar'20 still in place across states, the scale of economic activity being undertaken across states is limited and significantly lower than what it was prior to the lockdown. The decline in economic activity has severely affected the incomes of the state governments. At the same time, they have been required to incur additional expenditure towards relief measures and health facilities in connection with the pandemic. The lower income coupled with higher expenditure has resulted in unanticipated strain to the state government finances.

Budget Estimates of State Governments 2020-21

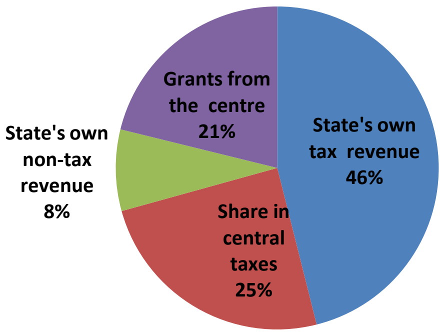
The states and UTs had presented their budgets for 2020-21 before the onset of the pandemic in the country. As such, the projections made were based on the premise of prevalence of normal conditions and positive economic growth during the year. Given that economic activity is unlikely to revert to pre-lockdown levels in the current financial year, there would be divergence in revenues and expenditure of states from what was budgeted for 2020-21.

- Based on the budget estimates, the aggregate size of state budgets for 2020-21 is Rs. 41 lakh crores, a 1.5% increase from that in 2019-20.
- The aggregate revenues of all states are budgeted at Rs. 32.1 lakh crores which is nearly 2% higher on a year –on-year basis. 46% of the revenues of the states are estimated to come from the central government by way of state's share

in central taxes (25%) and grants (21%). State's own tax revenue is budgeted to account for 46% of its revenues in 2020-21.

- The revenue expenditure of states is budgeted to increase by 2.8% (y-o-y) to Rs. 32.3 lakh crores. Nearly 80% of the total expenditure of states is towards revenue expenditure which is largely committed in nature.
- The fiscal deficits of states have been budgeted to increase by 15% to Rs.6.35 lakh crores in 2020-21 from that in 2019-20.
- The aggregate revenues of all states in 2020-21 is budgeted to be 37% more than that of the central government while its expenditure is estimated to be 25% higher

Exhibit 1: Revenue Receipts of States - 2020-21



Source: CMIE and CARE Ratings calculations

Assessment of the financial position of States so far in 2020-21

The lockdown of the last 6 months has severely impacted the finances of all state and UTs. Constrained by the sharp fall in revenues they have had to compress capital expenditure as well as seek market borrowings. Lower capital expenditure and an increase in borrowings have adverse implications for the state's future growth and employment potential.

Based on the unaudited finances of 16 states for the 4 month period Apr-Jul'20 it is seen that

Table 1: Financial Position of 16 States Apr-Jul'20

	Up to Jul'20: Rs Crs	Up to Jul'19: Rs. Crs	% change
Revenue receipts	**3,05,136**	**3,30,322**	**-8**
Tax revenue	1,88,417	2,35,552	-20
State' s Own Non-tax revenue	20,814	28,325	-27
Grants-in-aid and contributions	95,905	66,446	44
Capital receipts	**1,36,405**	**77,996**	**75**
Borrowings & other liabilities	1,36,016	71,635	90
Revenue expenditure	**3,93,802**	**3,49,440**	**13**
Capital expenditure	**43,391**	**53,264**	**-19**
Fiscal deficit	**1,43,573**	**66,585**	**116**

Source: CMIE and CARE Ratings calculations

- States revenues receipts have fallen by 8% from that in Apr-Jul'19.
- Tax revenue have seen a year-on-year decline of 20% and non-tax revenue by 27%.
- The sharp fall in tax and non-tax revenues of states has been partly offset by the increase in grants. There has been a 44% increase (y-o-y) in the grants received by states during Apr-Jul'20.
- Total expenditure of states has increased by 6% during Apr-Jul'20 v/s Apr-Jul'19. This increase is led by revenue expenditure which grew by 13% on a year-on-year basis. Capital expenditure of states on the other hand witnessed a contraction of 19% in this period.
- The fiscal deficit of states as of Jul'20 was 116% more than that in Jul'19.
- Borrowing and other liabilities of states were 90% higher as of Jul'20 v/s Jul'19
- The market borrowings of state governments so far in the financial year (7 Apr-22 Sep'20) has been 45% higher (at Rs. 3.26 lakh crores) than that in the corresponding period of year ago.

GST compensation to state

The GST (Compensation to States) Act 2017 stipulates that states are entitled to compensation for the loss of revenue on account of implementation of GST for a period of 5 years (till 2022). The compensation payable is the difference between the projected revenue (14% growth rate over 2015-16) and actual revenue. The compensation is paid from the GST Compensation Fund which is built on the inflows through the collection of GST Compensation cess levied on luxury items and demerit goods. Owing to the unprecedented huge losses to revenue on account of the pandemic, there is a shortfall in the GST Compensation Fund, affecting the compensation to states.

The GST council has proposed 2 options for meeting the shortfall in GST compensation to states both of which involve borrowing by the state.

1. States to borrow Rs.97,000 crs -which is the estimated shortfall arising out of GST implementation- by way of issue of debt under a Special Window coordinated by the Ministry of Finance. The servicing of this debt will not be borne by the state. It will be paid from the proceeds of the GST Cess, the period of levy of which may be extended as required. Also, this borrowing will not be counted as debt of the state for norms of the Finance Commission.
2. States to borrow from the market Rs.2,35,000 crs which is the estimate of all types of revenue loss due to the Covid impact (including the loss due to GST implementation). The interest of this borrowing is to be paid from the state's own sources while the principal would be paid from the proceeds of the GST Cess. Only Rs.97,000/- of borrowings will not be treated as debt of the state for norms of the Finance Commission.

Presently 21 States and UTs that have agreed to meet the shortfall through borrowings have opted for option 1 i.e. borrow Rs.97,000 crs from the Special Window. 9 states have not yet opted for either of the options. These include – Jharkhand, Kerala, Punjab, Maharashtra, Rajasthan, Tamil Nadu, West Bengal, Telangana and Delhi

The shortfall in GST compensation further pressures the finances of states which are already pressurized from the sharp decline in revenues from own sources due to the restricted economic and commercial activity in their regions. The implications for the fiscal deficit of states would be linked with the shortfalls in revenues. The increase in expenditure too would have a bearing.

Estimate of fiscal deficit of states for 2020-21

As per the budget estimates, the aggregate fiscal deficit of states for 2020-21 would amount to Rs.6.35 lakh crores. The states' fiscal deficit would translate to 2.8% of the GDP for 2020-21. India's nominal GDP for 2020-21 is estimated to be Rs.225 lakh crores in the Union Budget which is a 10% growth over 2019-20. However, given the sharp fall in economic activity consequent to the lockdown, the Indian economy is expected to see a contraction in economic growth in 2020-21. We expect the India's nominal GDP growth for 2020-21 to contract by 3% (to Rs. 197 lakh crores) from that in 2019-20.

Assumptions made for projection of state's fiscal deficit

1. India's nominal GDP growth in 2020-21: Rs. 197,29,653 crores (-3% growth y-o-y)
2. Ceteris paribus conditions prevail i.e. there are no expenditure cuts nor additional revenue source from what has been estimated in the state budgets

Our projections indicate that the fiscal deficit of states in 2020-21 could increase by as much as 1.6% over the budget estimate of 2.8% to 4.4% of India's GDP. The basis/ rationale for the projection is as follows

- Of the Rs.2.35 lakh crores that is estimated by the central government to be the revenue loss for states on account of the Covid impact, only Rs. 97,000 crores can be borrowed by state's from the Special Window facilitated by the Ministry of Finance (the repayment of which need not be done by the state). The balance Rs. 1.38 lakh crores of revenue loss will have to be met through market borrowings by states. This would add to their fiscal deficit which would increase to Rs.7.73 lakh crores (from Rs. 6.35 lakh crores) and raise their fiscal deficit to 3.9% of GDP (a 1.1% increase from the budget estimate).
- Even though Rs.97,000 crore is to be borrowed through the Special Window and may not be treated as debt for norms of the Finance Commission it nevertheless adds to the debt/ liabilities of the nation. On including this amount as a part of the revenue loss of states, their fiscal deficit would increase to Rs. 8.70 lakh crores or 4.4% of GDP.

Central Government finances – upward revision in fiscal deficit for FY21

The Central Government finances for April-July FY21 highlights the lockdown led financial stress faced by the government with sharp decline in its income and an increase in expenditure which has consequently led to the significant widening of the fiscal deficit. For these 4 months, the fiscal deficit is Rs 8.2 lakh crs, 103% of the budgeted fiscal deficit for FY21(BE). In February, 2020, the Government had presented the Budget targeting the fiscal deficit at 3.5% of GDP but the assumptions made then do not hold true following the outbreak of the COVID-19 pandemic.

Considering revision in various projections and the Central government accounts released for 4 months during the fiscal FY21, we estimate fiscal deficit (as a % of GDP) to be 9% during the year. The details of the shortfall in revenue, increase in expenditure and the various assumptions made in the calculation have been provided below:

Table 3: Gross fiscal deficit of the Central Government- Projection

Particulars	Rs lakh crs
Shortfall in tax revenues	3.9
Shortfall in disinvestment	1.2
Shortfall in non-tax revenues	0.8
Total revenue shortfall (A)	5.9
Additional expenditure (B)	3.8
Impact on fiscal deficit (A+B)	9.8
Fiscal deficit in FY21 (BE) - as per Budget	8
Likely fiscal deficit in FY21	17.8
Likely GFD (as a % of GDP)	9 % of GDP

Source: CARE Ratings

- Tax revenues could see a shortfall of Rs 3.9 lakh crs from FY21(BE). This shortfall has been computed based upon the following two assumptions:
    - We have assumed a shortfall of 10% in case of GST, which accounts for almost 30% of net tax revenues of the government
    - We have assumed a shortfall of 30% in case of all remaining tax revenue sources of the government like personal income tax, corporate income tax, customs, excise duty, which together account for 70% of net tax revenues.
- So far this year (April-July), disinvestments have been only Rs 2.93 crs as against Rs 2.1 lakh crs as per FY21 (BE). We expect a shortfall of around Rs 1.2 lakh crs during the year owing to uncertainty in disinvestment of key entities like BPCL, LIC, Shipping Corporation of India, Concor.
- In case of non-tax revenues, we expect revenue to be lower by around Rs 80,000 crs chiefly on account of lower dividends from public sector banks, public sector enterprises and fees from the telecom sector.
- Additional expenditure by the government is estimated at around Rs 3.8 lakh crs based on the following announcements:
    - Additional spending under the PM Garib Kalyan Yojana is around Rs 1.67 lakh crs. Out of the total announcement of Rs 1.92 lakh crs, we have excluded the amount of the cash transfers to the farmers (PM-KISAN) as the same had already been budgeted in FY21.
    - Out of the 5 tranches of the economic package announced during May 13-17, we expect expenditure of around Rs 80,000 crs to be incurred in FY21.
    - As announced by the Prime Minister, the extension of free ration till November is likely to cost the exchequer around Rs 90,000 crs.
    - Transfer to states, as per the 1st supplementary budget is around Rs 46,600 crs. This includes post devolution revenue deficit grant as per the recommendations of the 15th FC.

- If any of the announced expenditure is clubbed or substituted with any other budgeted expenditure head, additional spending could be lower to that extent.

Combined fiscal deficit: State and Central Government

Based on the projections made for the state and central government fiscal deficit in the earlier sections, their combined fiscal deficit for 2020-21 could see a sharp increase from the budget estimates of 6.4%.

As per the budget estimate, the combined fiscal deficit in 2020-21 was to decline by 0.95% from that in 2019-20, led by 1.06% decline in the central government fiscal deficit. The state government fiscal deficit was budgeted to see an increase of 0.1% (y-o-y).

The combined fiscal deficit in 2020-21 could increase by as much as 7% over the budget estimate. We expect it to be in the region of 13% in the technical sense as the Rs 97,000 cr of direct borrowing by states is not being treated as fiscal deficit. But the effective number will be around 13.4% including this amount as finally it adds to the debt of all governments.

Contact:
Madan Sabnavis
Chief Economist
madan.sabnavis@ careratings.com
91-22-68374433

Kavita Chacko
Senior Economist

Sushant Hede
Associate Economist

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-22-68374424

CORPORATE OFFICE:
CARE Ratings Ltd.
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400 022.
CIN: L67190MH1993PLC071691
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457 I E-mail: care@careratings.com
www.careratings.com Follow us on /company/CARE Ratings
/company/CARE Ratings