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Tamil Nadu Needs to Widen Revenue Base, Increase Collection for Better Fiscal Sustainability

R. Srinivasan Jul 25, 2016

The Finance Minister of Tamil Nadu, O. Panneerselvam, presents the State budget for 2016-17 on July 21, 2016, after the AIADMK government took charge for the second consecutive time. Photo: B.Jothi Ramalingam.

*Budget making at the State level in India has undergone changes since the implementation of the fiscal responsibility legislation and the successive Finance Commission recommendations. For a high-performing State such as Tamil Nadu, this means balancing its equity-based programmes with shrinking allocations and space for revenue mobilisation. Associate Professor of Econometrics, University of Madras, **R. Srinivasan**, analyses the 2016-17 budget for Tamil Nadu and holds out the caution that the State could fall into a debt trap if it does not augment its own revenues, plan for reducing public expenditure, and simultaneously improve efficacy of public service delivery.*

Fiscal debate in Tamil Nadu has always been around two important issues - one is about financing ever-increasing subsidies and social sector expenditures, and the other is the inadequate financial transfers from the Union Government. The 2016-17 Revised Budget[1] of the Government of Tamil Nadu, presented to the State Assembly on July 21, 2016, is no exception. The allocation for subsidies and transfers in

2016-17 is budgeted to be Rs 68,211.05 crore, an increase of 14.7 per cent over the revised estimate of 2015-16. A substantial portion of this will be transfers to local bodies, autonomous and aided educational institutions, and health care centres. This part cannot be strictly treated as subsidies. Given the plethora of new subsidies in electricity, marriage assistance and scooters for working women to name a few, the increase of subsidies could be high. Since 2015-16, when the recommendations of the Fourteenth Finance Commission were implemented, Tamil Nadu has been blaming the reduced share in central tax revenue and grants for both plan and non-plan expenditures as one of the reasons for growing fiscal deficit in Tamil Nadu.

In the last three years, the fiscal deficit of the State has been galloping by 11.4 per cent in 2014-15, 19 per cent in 2015-16 (RE) and 25 per cent in 2016-17 (BE). This undeterred increase in fiscal deficit is due to both slow growth of revenue as well as uncontained faster growth in public expenditure. The State's own revenue is estimated to increase by only 5.1 per cent compared with the 11.5 per cent increase in Union financial transfer. Of this Union financial transfer, share in central taxes is budgeted to increase by 8.8 per cent and central grants by 14 per cent. Taking these into consideration, the total revenue receipt for the State is expected to increase only by 7 per cent this fiscal. The growth of non-interest expenditure, including capital outlay, is expected to be 10 per cent and the interest payment to increase by 15 per cent.

Disturbing trend in State's own Revenue

The disturbing trend is the growth of State's own Tax Revenue (SoTR). In spite of the fact that much of the commercial tax revenue is fetched through the non-VAT items like petroleum products, liquor, gold and sugarcane, (as these are cascading taxes and are likely to generate more revenue) the general tax revenue is not buoyant. The Gross State Domestic Product (GSDP) of Tamil Nadu has grown by 11.0 per cent and 12.9 per cent in 2015-16 and 2016-17 respectively; whereas the SoTR has grown at a little lesser pace - 9.7 per cent and 5.2 per cent. As the growth rate of tax revenue is less than the growth rate of tax base (GSDP), the Tamil Nadu tax system has not been buoyant in recent years. Further, the SoTR is budgeted to be low for 2016-17 and thereafter it is expected to remain low because of the electoral promise of phased implementation of prohibition on sale of liquor in the State.

Thus, Tamil Nadu's dependence on non-VAT-able tax sources is clearly defined. As the revenue from such tax sources is declining; the State should get out of this conundrum by improving revenue collection from other tax sources. For instance, faster urbanisation should result in faster growth in revenue through Stamp Duty on property transfers and Motor Vehicle Tax. However, one sees no any substantial increase in these revenues. The budgeted revenue for 2016-17 from stamps and registration is Rs 9,858.17 crore, an increase of just 4 per cent over the revised estimate for 2015-16; similarly, the revenue from Motor Vehicle Tax is estimated to be Rs 4,793.91 crore in this fiscal – an increase of 9 per cent over the revised estimate for last year. Commodity prices are volatile at the global level and the political compulsion for increasing the intensity of prohibition on sale of liquor should push the State government to venture into new areas for revenue mobilisation.

Non-tax revenue appears to have dropped off the State's fiscal radar. As Tamil Nadu is committed to provide goods and services through government departments and public sector undertakings only at cost or even at less than cost in most of the cases, it dismisses any potential for additional revenue mobilisation through augmenting user charges. However, there is an urgent need for a fresh look at additional revenue mobilisation by the State government.

Union financial transfers to Tamil Nadu

The Chief Minister of Tamil Nadu made the following observations in the memorandum submitted to the Prime Minister last month.

"The unbalanced (distribution) formula adopted by the 14th Finance Commission treated Tamil Nadu most adversely. The reduction in the inter-se share of Tamil Nadu of 19.14 per cent represents the biggest loss in share amongst all States. … The very large drop in Tamil Nadu's share in the divisible pool is barely compensated by the increase in the overall devolution pool by 10 per cent and Tamil Nadu's overall share in Central taxes has increased by just 0.1 per cent from 1.59 per cent to 1.69 per cent. … the loss to Tamil Nadu due to reduction in its share in the divisible pool and the discontinuance of special purpose and state specific grants is estimated at Rs 6000 crore per annum."

Every Finance Commission alters the *inter-se* distribution formula and that is the major purpose for which the Finance Commission is constituted once in five years. In a country with glaring regional inequalities and where equity is the cornerstone of socio-economic policies of every level of government in a federal framework, successive Finance Commissions have given larger weights to indicators of backwardness in the distribution formula and hence lower share to States that exhibit more than national growth rate in income and revenue collection. Further the specific non-Plan grants by every Finance Commission should also change as the terms of reference for each Finance Commission is different. Hence, treating previous Finance Commission's awards as a benchmark for comparison is incorrect.

While the States' share in Union Government's net tax revenue has been increased from 32 per cent to 42 per cent in the 14 th Finance Commission, the Planning Commission has been abolished and many of the Centrally Sponsored Schemes were also abolished. These have cumulatively reduced the proportionate share of Tamil Nadu in these tied grants (for specific purposes) while that of the untied transfers (general purpose transfer) increased. Quite strangely the overall Union financial transfers in 2015-16 (the first year of 14 th Finance Commission Awards) increased by 21 per cent compared with 2014-15. In 2015-16, the share in central taxes increased by 25.7 per cent and grants increased by 16.7 per cent. The budget estimates of these two types of Union financial transfers for the year 2016-17 are 8.8 per cent and 14.1 per cent respectively. On an average, the growth in Union financial transfers has been higher than that of the State's own revenue and even higher than the State's GSDP.

The flow of financial transfers from the Union Government is a function of both their tax revenue collection in the Union Government and *inter-se* share in the allotted funds for States. As the Union Government is also facing a downswing in the economic growth, the buoyancy of central tax system is also declining. Nevertheless, the declining share in proportionate terms is adequately compensated by the absolute increase in the quantum of States' share in central tax revenue. In addition to the nuances of the transfer arithmetic, the new financial transfer system enhanced the autonomy of States in using the Union financial transfers should be a welcome feature for Tamil Nadu.

Growing Public Expenditure in Tamil Nadu

The non-interest public expenditure is budgeted at Rs 1,67,493.27 crore for 2016-17, an increase of 10 per cent over the revised estimate for 2015-16. The budget provision for interest payment for 2016-17 is Rs 21,215.67 crore, which is an increase of 15.6 per cent over the revised estimate for 2015-16.

The increase in public expenditure in general is not as much as the increase in interest payment; higher interest payment is a direct implication of the higher debt burden and higher cost of borrowing. This trend in interest payment will accelerate as the State has proposed to increase the fiscal deficit limits by amending the fiscal responsibility legislation, facilitating higher borrowing this year.

The State government, in order to fulfil the AIADMK's election promises, has proposed to allocate substantial public funds for the new subsidy schemes in 2016-17. It is proposed to waive Rs 5,780.92 crore of farm loans from cooperative credit societies, and the State government would provide the money with interest over a period of five years, the allocation for this scheme this year is Rs 1,680.73 crore.

The free electricity up to 50 units per month for domestic consumption would cost the State an amount of Rs 1,607 crore and the total power subsidy would be Rs 9,007 this fiscal year. Allocation for marriage assistance scheme is Rs. 703.16 crore due to doubling of 'gold for thali' from 4gm to 8gm and monetary assistance up to Rs 50,000. Grants to local bodies is also increased by Rs. 2,163.24 crore and such grants to other autonomous bodies have also been increased. In spite of increased allocation for many subsidies schemes, along with higher allocation for interest payment, curtailing the total public expenditure to a moderate increase of 10 per cent in 2016-17 over 2015-16 is puzzling. The total public expenditure, net of new subsidy and development schemes, should be quite low. This may be quite costly in terms of sustaining the development efforts and maintaining the efficiency of public administration and delivery of public services. (As the complete Annual Finance Statement is not yet available, it is not possible to identify the sectors in which substantial expenditure pruning has been done.)

Expanding borrowing limits of the State government

Tamil Nadu is complacent that the fiscal deficit ratio has not crossed 3 per cent (that is a ratio of fiscal deficit to GSDP). The Tamil Nadu Fiscal Responsibility Act, 2003, as amended in 2010, stipulated to maintain revenue balance and fiscal deficit ratio at 3 per cent since 2011-12. In the last three years, the fiscal deficit ratio has always been up to the brim. Further, the Annual Financial Statements for the years 2013-14 and 2015-16 also show revenue deficit, and it is budgeted to have revenue deficit this fiscal as well. Citing the unavoidable deficits, the Finance Minister has proposed to amend the Tamil Nadu Fiscal Responsibility Act, 2003 so that the state government's borrowing limits could be increased. With the amended the Fiscal Responsibility Act, 2003 the state government has proposed to increase the fiscal deficit ratio to 3.34 per cent in 2017-18 and to bring it back to 2.96 per cent in 2018-19 and the revenue deficit will also exist in these years.

Every Finance Commission fixes the deficit limits and debt limits for every State government. The 14 th Finance Commission recommended that the fiscal deficit ratio be at 3 per cent and revenue balance should be zero or positive throughout the award period 2015-20. It also provided for a relaxation of these stipulations:

"The fiscal deficit targets and annual borrowing limits for the States during our award period are enunciated as follows:

(i) Fiscal deficit of all States will be anchored to an annual limit at 3 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year.
(ii) States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year.
(iii) The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum fiscal deficit-GSDP limit of 3.5 per cent in any given year.
(iv) The flexibility in availing the additional limit under either of the two options or both will be available to a State only if there is no revenue deficit in the year in which borrowing limits are to be fixed and the immediately preceding year."

Of the four conditions given here, the State government satisfies the condition (i) and does not satisfy condition (ii) (*vide* Table given here). Nevertheless, using condition (iii) the State government proposes an amendment to its fiscal legislation. If Tamil Nadu amends the Fiscal Responsibility Act, 2003, in order to increase fiscal deficit ratio to 3.5 per cent in 2017-18, then as per condition (iv) mentioned above, its revenue deficit should be zero in 2016-17 and 2017-18. Tamil Nadu does not satisfy this condition. Though the Finance Commission has stipulated conditions for the relaxation of deficit targets, it is the Union Government that has to implement and the Union

Government shall relax any of the conditions, and particularly condition (iv) here. If so, then Tamil Nadu can amend its Fiscal Responsibility Act, 2003.

The direct implication of higher borrowing would be higher debt servicing charges in the years to come and it would be difficult of contain revenue deficit. Borrowing costs of the State government will increase as it is likely that the State government would take over the debts of electricity distribution company, TANGEDCO. All the proposed expenditures for the coming years, like pay hike for government employees, compensation under farmers' loan waiver scheme and other subsidies, will add to the revenue expenditure, further damaging the chances of achieving revenue balance.

It is quite likely that Tamil Nadu would get into a debt trap if it does not augment its own revenues as well as plan for reducing public expenditure, and simultaneously improve efficacy of public service delivery. Debt management would be problematic unless adequate and regular cash flows in the treasury is assured through timely collection of tax revenue.

Tamil Nadu Budget at a Glance

Particulars	2014-2015 (Accounts)	2015-2016 (Revised Estimates)	2016-2017 (Revised Budget Est)	% Increase in 2015-16	% Increase in 2016-17
Revenue	**1,22,420.44**	**1,38,306.20**	**1,48,175.09**	13.0	7.1
State's own Revenues	87,007.14	95,468.95	100,415.83	9.7	5.2
Tax	78,656.54	86,537.70	90,691.87	10.0	4.8
Non-Tax	8,350.60	8,931.25	9,723.95	7.0	8.9
Central Transfer	**35,413.30**	42,837.25	**47,759.27**	21.0	11.5
Shared taxes	16,824.03	**21,149.89**	23,018.12	25.7	8.8
Grants	18,589.27	21,687.38	24,741.15	16.7	14.1
Non-Interest Expenditures	133,920.47	152,315.68	167,493.27	13.7	10.0
Salaries (including GIA for education)	37,070.31	41,445.35	45,542.18	11.8	9.9
Pensions & Retirement Benefits	15,823.56	17,543.96	18,868.16	10.9	7.5
Non-Wage O&M	9,498.47	10,694.00	10,184.59	12.6	-4.8
Subsidies and transfers	50,713.33	59,741.47	58,211.05	17.8	14.2
Other Revenue Expenditures	43.93	12.45	7.81	-71.7	-37.3
Capital Outlay	17,802.98	20,765.06	22,368.85	16.6	7.7
Net Lending	2,968.19	2,113.39	2,310.53	-28.8	9.3
Primary Surplus(+)/Deficit(-)	**-11,500.03**	**-14,009.49**	**-19,318.18**	21.8	37.9
Interest Payments	15,678.71	18,350.10	21,215.67	17.0	15.6
Interest Payments/Total Revenue Receipts	12.81 (%)	13.27 %	14.32 %	3.6	7.9
Revenue Surplus(+)/Deficit(-)	**-6,407.56**	**-9,481.14**	**-15,354.47**	48.0	61.9
Revenue Surplus(+)/Deficit(-) over TRR %	-5.23 %	-6.86 %	-10.07 %	31.2	46.8
Revenue Surplus(+)/Deficit(-) over Fiscal Surplus(+)/Deficit(-) per cent	23.59 %	29.30 %	39.11 %	24.2	33.5
Fiscal Surplus(+)/Deficit(-) (Adjusted)	**-27,162.45**	**-32,359.59**	**-40,533.84**	19.1	25.3
Fiscal Surplus(+)/Deficit(-) (Adjusted) over GSDP %	-2.49%	-2.67 %	-2.96 %	7.2	10.9
Gross State Domestic Product (GSDP)	10,92,564.00	12,12,668.00	13,69,494.00	11.0	12.9

Source: Budget speech 2016-17, Government of Tamil Nadu.**References:**

1.^ An interim budget was tabled on February 16, 2016, as the General Election to the State Legislative Assembly was held in May 2016.
2.^ Full Text: Tamil Nadu Chief Minister's Memorandum to the Prime Minister of India (June 14, 2016).

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