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Fiscally Unsustainable Election Promises in Tamil Nadu

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Success at Tamil Nadu's elections has revolved around the politics of subsidies for decades. In this analysis, *R. Srinivasan*, ***argues that with fiscal space for Tamil Nadu shrinking, the next government will have to resort to additional borrowing if it were to both abolish prohibition and deliver upon election promises.***

Promises to deliver select government services and public goods at substantially subsidised prices or in the case of certain products and services, free of cost, have become an expected feature in election manifestoes in Tamil Nadu. No major party is an exception to this unwritten code. The real questions that lie behind these promises – financing the ballooning public expenditure as a result of such promises, and the availability of surplus money with the government, to highlight two – are invariably met with a common answer by contenders to power: "we will mobilise additional revenue". However, none, be it an incumbent or the aspirants, seems to have a credible answer to the question: "from where would this additional revenue be mobilised?"

An election manifesto also provides a preview to a party's priorities for spending public revenue, if elected to power. This prioritisation should be questioned in the context of the existing inadequacies in the provision of basic necessities like drinking water, sanitation, quality public health and public education, roads, social security systems like pensions for old-age, destitute, and special people. However, these are neither quantified nor debated. Moreover, when it comes to promises regarding industrial and infrastructure growth, it is important to quantify the hidden subsidies in the provision of land and dedicated public utilities to industrial houses and the hidden social costs of displacement of people due to acquisition of land for such projects.

Broadly speaking, there are three modes of financing new public expenditure:

1. reduce the allocation for on-going schemes and reallocate them to new ones;

2. raise the State's Own Tax (SOT) and Non-tax Revenue and get more grants from the Union government; and

3. borrow at market interest rate from financial institutions. State governments can borrow only from financial institutions and it is mediated by RBI, which does not directly lend money to governments.

1. Reallocating funds from existing schemes to new schemes

This is the usual approach to get more money for new schemes. Every year, some existing schemes will get terminated automatically, mostly schemes that involve capital expenditure and those that are given matching grants by the central government. Some of the schemes will be deliberately clubbed with other schemes to reduce the expense on one of the clubbed schemes. A few such occasions will arise when the Union government gives money for a new scheme, which may actually be an existing scheme in a State. However, such Union grants may not materialise because the State has already terminated or has planned to terminate the scheme that is listed in the current Five Year Plan. The Planning Commission was abolished and replaced with NITI Aayog so there will not be a Five Year Plan from 2017-18.

For instance, when the ruling All India Anna Dravida Munnetra Kazhagam (AIADMK) came to power in 2011, it discontinued the scheme of distributing free colour televisions, and replaced it with providing wet grinders and table fans. In 2012-13, the AIADMK released a Vision Document -2023, and as a sequel announced several infrastructure programmes with a total allocation of Rs. 2500 crore. However, the Comptroller and Auditor General (CAG) Report, 2015 notes that all these infrastructure schemes were shelved, and obviously the money should have been reallocated to other schemes.

There are instances where important public utilities are curbed to finance the schemes that flow from the election manifesto, or what the ruling party considers as its flagship programme. On the whole, saving through discontinuance of existing schemes, reducing expenditure and sub-optimally providing public utilities will generate some money for the new government to finance its pet schemes. When a new government is formed the first assignment to the Finance Department is usually to prepare the schemes to be discontinued and the schemes that could be given lower outlay and the consequent savings that should be available for new schemes.

With the passage of time, the scope for reducing existing expenditure is declining with increasing committed expenditure of the government. For instance, in the three-year period, 2011-12 to 2013-14, the allocations for wages and salaries of government employees, grants including salary grants to aided institutions and local bodies, pension and interest payments were Rs. 23,136 crore, Rs. 20,622 crore, Rs. 12,679.67 crore and Rs. 10,493.67 crore, respectively, aggregating to Rs. 66,931.34 crore.

These committed expenditures were 87 per cent of Tamil Nadu’s Own Tax Revenue (OTR), without including subsidies. Though subsidies are ‘discretionary expenditures’, the political fallout of reducing existing subsidies are grave and hence provide limited scope for manoeuvrability [1] .

Some of the big-ticket and debated subsidy schemes are given in Table 1.

Table 1: Expenditure on major subsidy schemes – 2011-12 to 2013-14 (Rs. crore)

SUBSIDY	AVERAGE FOR THREE YEARS	SUBSIDY	AVERAGE FOR THREE YEARS
Food subsidy through PDS	4,900.00	Uniforms to school children	292.73
Electricity subsidy for domestic consumption	1,814.48	Bicycles to Higher Secondary School children	173.18
Students' bus fare	449.41	Distribution of sheep/goat scheme	154.39
Distribution of sarees and dhotis to people below poverty line	1,194.26	Menstrual Hygiene Programme-distribution of sanitary napkins for adolescent girls	51.08
National Agriculture Development Programme	107.48	Distribution of milch cows scheme	42.53
Electricity subsidy for power loom weavers	463.83	Distribution of Laptops to Higher Secondary School children	820.02
Free supply of grinders, fans, etc	1,163.78	Maternity Assistance Scheme	605.28
Marriage assistance scheme – 4gm gold	632.09	Health Insurance Scheme	438.10
GRAND TOTAL			**13,302.43**

Source: CAG report: State Finances, Tamil Nadu 2015.

Table 1 does not give the complete lists of subsidies, but the major schemes as listed in it, incurred an expenditure of Rs. 13,302.43 crore, accounting for 17.3 per cent of Tamil Nadu's OTR. Therefore, the aggregate of committed expenditures, that is, wages and salaries, pensions, grants, interest payments, and subsidies together were 104.3 per cent of the State's OTR. Moreover, of the subsidies that are implemented through PSUs and departmental organisations such as the Tamil Nadu Water supply And Drainage (TWAD) Board and Chennai Metrowater, are not included here.

There are also some instances of off-budget borrowings, where the government, instead of borrowing directly to finance its expenditures, may ask the autonomous bodies under its control to borrow to meet the public expenditure requirements. It is not clear if all the subsidy expenditures incurred by autonomous bodies were reimbursed by the State government. For instance, the CAG Report 2015 notes that two government companies, namely the TWAD Board and the Tamil Nadu Co-operative Housing Federation Limited have borrowed Rs. 48.79 crore, of which only Rs. 23.25 crore was repaid by the State government. The borrowings were made by the government companies to finance the implementation of State government schemes. There is a need to keep a watch on such off-budget borrowings to know the exact amount of subsidies rolled out by the State government.

Therefore, reducing expenditure would require rationalisations of subsidies, reduction of interest payments through reducing debts of both the State government and its undertakings and contracting loans at lower interest rates, and finally reducing expenditure on salaries and wages. The last one is important in this context as the implementation of the Seventh Pay Commission is looming large on the horizon, with the potential to further affect the State's public finances.

2. Potential for Additional `Own Revenue Mobilisation' in Tamil Nadu

Tamil Nadu has always been one of the top three States mobilising OTRs. The State's high tax revenue collection is mainly driven by two factors – one, the high tax revenue from the liquor sector and the larger tax base offered by its larger urbanised and non-farm sector. Urbanisations provides the tax base for collection of Stamp Duty (SD) and Registration Fee (RF) on conveyance of immovable property and the non-farm sector, particularly the value addition in industrial and trade sectors, provides the sales tax base. Tamil Nadu is, therefore, in an enviable position of having an inelastic tax source like the liquor trade and a buoyant tax base emanating from the non-farm sector.

The tax effort of a State is measured in terms of OTR–Gross GSDP ratio (hereafter own tax ratio). Table 2 provides a comparison of the tax ratios of Tamil Nadu and Gujarat for evaluating Tamil Nadu's slackness in tax effort [2] . [For choice of Gujarat as a comparable State, please refer explanatory note 2.]

Table 2: Tax efforts of Tamil Nadu and Gujarat – A comparison

(Rs. Crore, percentages in brackets)

PARTICULARS	GUJARAT (AVERAGE OF 2011-12 TO 2013-14)	TAMIL NADU (AVERAGE OF 2011-12 TO 2013-14)
State's OTR Ratio to GSDP	57,478.69 (7.45)	76,915.03 (8.96)
State Excise	112.18	7,845.54
Sales Tax on Liquor		13,251.35
Total tax on liquor	112.18	21,096.98
Non-liquor tax revenue Ratio of GSDP	57,366.51 (7.44)	55,818.14 (6.50)
GSDP	77,1444	85,8600
Non-farm sector's contribution to GSDP	(79.00)	(89.30)
Urbanization	(43.00)	(49.00)

Source: RBI report on State Finances, various years and Annual report (2014-15) of Commercial Taxes Dept, Government of Tamil Nadu.

Tamil Nadu has a larger tax base in terms of GSDP, which is about 11 per cent more than that of Gujarat. However, the tax ratio of Tamil Nadu is 8.96 per cent and it is 1.51 percentage points more than 7.45 per cent of Gujarat. Tamil Nadu has not only a larger tax base in terms of higher GSDP, but also higher tax ratio. Thus, the OTR of Tamil Nadu is nearly 34 per cent higher than that of Gujarat. This puts Tamil Nadu in a more comfortable revenue position than Gujarat.

Promises of Prohibition and its effect on State finances

As both excise and sales tax revenues from liquor are inelastic, they are a constant source of ever increasing revenue for the State. With Tamil Nadu now in election mode, every political party in the fray has promised prohibition in some form or the other, either total or partial. Both approaches, however, will have a substantial adverse impact on revenue potential of the State.

It is also important in such an analysis of the state of public finance and election promises to compare Tamil Nadu's tax effort in other taxes with that of Gujarat to get a picture of the State's untapped revenue potential, if any. To arrive at this figure, both excise duty collections and sales tax revenue from the liquor sector are deducted from the total OTR of the two States. Astonishingly, the OTR (without tax revenue from liquor sector) of Tamil Nadu, in absolute terms, is less by Rs. 1,548.37 crore than Gujarat's OTR of Rs. 55,366.51 crore.

This is a good indicator that the tax effort of Tamil Nadu is not as high as that of Gujarat. Table 2 makes it evident that Gujarat has a smaller non-farm sector and lower level of urbanisations than Tamil Nadu, but is still it is able to collect higher amount of tax revenue. Thus there is a huge tax potential that is untapped in Tamil Nadu. If Gujarat's non-liquor tax ratio of 7.44 per cent were applied to Tamil Nadu's tax base, then the tax collection would be Rs. 63,879.84 crore, that is, Rs. 8,061.70 crore more, which is the tax revenue gap in comparison with Gujarat. Given the higher levels of industrialisation and urbanisation in Tamil Nadu, the actual revenue gap should ideally be larger than this.

Why does this larger revenue gap exist in Tamil Nadu? Is it due to corruption in tax administrative machineries or general weakness in tax administration or both? Tamil Nadu's revenue-slack situation is evident from a further disaggregation of the sales tax revenue collection. Out of Rs. 53,046.32 crore of sales tax revenue collected in the three-year period 2012-13 to 2014-15 in Tamil Nadu, nearly 45 per cent, that is, Rs. 23,675.24 crore, was collected from a handful of dealers in liquor, petrol, tobacco and sugarcane. Thus, a major portion of sales tax is collected with relatively lower collection costs. The remaining Rs. 30,221.07 crore of sales tax revenue was collected as VAT, including Central Sales Tax (CST). It appears that the collection of VAT is not commensurate with the size of the tax base. Revenue from CST may highlight this point. Gujarat which has a lower industrial base in absolute terms, was able to collect Rs. 5,319.28 crore through CST compared to Rs. 3,106.97 crore collected by Tamil Nadu. Gujarat was also able to collect more revenue through Land Revenue, Urban property tax, and Entertainment tax. However, the stamp duty collection in Gujarat was far below that that of Tamil Nadu.

There is some evidence to believe there is laxity in the collection of tax revenue in Tamil Nadu. If the tax collection machinery is made efficient and corruption-free, then Tamil Nadu can gradually, and of course partially, compensate the revenue loss that may arise from implementation of prohibition from the next fiscal year.

Almost all the States are very lax in collecting non-tax revenues such as user charges, and are running their Public Sector Undertakings (PSUs) at least at breakeven. Tamil Nadu's OTR is around 10 per cent per cent of the total OTR of all major States, (excluding special category states like hilly Himalayan and north eastern states) whereas its own non-tax revenue's share is only around 6 per cent of the own non-tax revenue of other States. In the three years, 2011-12 to 2013-14, the average non-tax revenue of Tamil Nadu was Rs. 7,193.67 crore.

A government can collect non-tax revenue through user charges for the public utilities it provides. And, there are other components of non-tax revenue such as profits from PSUs and interest collections on the loans it has provided to other institutions. Therefore, the total expenditure of the State government can be considered as its base for collection of non-tax revenue. In other words, if the total expenditure is higher its ability to collect non-tax revenue also should increase. The non-tax revenue as a proportion of the State's total expenditure was 6.1 per cent. Interest receipts is the single largest source of non-tax revenue, which was about Rs. 2,459.3 crore and other earnings by all the departments put together was Rs. 4,683 crore.

The dividend and profits from the State's PSUs was only Rs. 51.3 crore. These PSUs could have been a major of source of non-tax revenue, but for the accumulated loss of Rs. 50,826.43 as on March 31, 2014. The turnover of PSUs as a ratio of GSDP of the State declined from 10.3 in 2011-12 to 9.77 in 2013-14. During this period, the debt of PSUs as a ratio of total turnover of PSUs debt-turnover ratio also increased from 0.66 to 0.93. Thus, the value addition by PSUs in the State's economy is declining because turnover is declining, whereas its debt is increasing with higher level of accumulated losses. Therefore, the turnaround of PSUs, particularly of the electricity generation and distribution companies, continues to be a mounting challenge year after year for the Tamil Nadu State government. Subsidising electricity without reducing the average cost of generation reduces the ability of power utilities to invest in capacity expansion and to increase efficiency in production.

Promises to reduce milk price on one hand and to increase procurement price on the other, is a sure recipe for disaster of State PSUs such as Aavin. Increasing procurement prices of cereals and sugarcane without transparent costs of cultivation calculations and increasing the number of agricultural produces in the list of commodities under Minimum Support Price system, without investing in storage and processing facilities will also be problematic for Tamil Nadu Civil Supplies Corporation. The scope for improving the financial viability of the State's PSUs is declining with each election, as parties promise to provide goods and services from these enterprises at prices far less than the costs of production without transparent budget support for such subsidies, which also restricts the potential to raise additional revenue through non-tax sources for Tamil Nadu.

3. Financial Transfers from the Union Government

Despite the constitutional framework of the quasi-federal nature of the Indian governance system, every State, be it a developed one and a developing one, accuses the Union government of reducing transfers to States.

The Indian States get financial transfers through three major routes from the Union Government. The share in central taxes, decided by the Finance Commission is an untied grant and constitutes the single largest source of such financial transfers. The other two being the Plan grants to support State plan schemes and grants for implementing Centrally Sponsored Schemes (CSS). Both these grants are tied in nature, as they are tied to implementing a specific set of schemes. While the Finance Commission successively increases the States' share in central taxes, the central assistance for plans in States has been declining. However, States like Tamil Nadu have complaints such as reduction in relative share in the central taxes and reducing plan grants over the years.

Tamil Nadu is unhappy that its share in *inter se* general tax revenue of the central government was reduced from 4.969 per cent to 4.023 per cent, and in service tax revenue from 5.04 per cent to 4.10 per cent by the 14th Finance Commission compared with the 13th Finance Commission. What is important to note here is that the 14th

Finance Commission increased overall States' share in central tax revenue to 42 per cent from 32 per cent, recommended by the 13th Finance Commission. In absolute terms Tamil Nadu stands to gain here, because out of the total central revenue, as per the 13th Finance Commission recommendation, Tamil Nadu got 1.59 per cent of the central tax revenue, whereas as per the 14th Finance Commission formula Tamil Nadu will get 1.69 per cent of the central tax revenue. Further, its share in central tax revenue shall decline or shall not increase as excepted if the buoyancy of the central tax is less than one. This has been the case in recent years.

Tamil Nadu has been one of the States strongly arguing against the plan grant distribution, as planning itself is a centralised process and against the spirit of federalism. Further it has also been arguing against the proliferation of CSSs. Now that the planning commission is dissolved and number of CSSs is reduced, these have, in turn, reduced the plan allocation in the central budget and consequently the transfers to the States are also declining sharply.

In the future, particularly after the Twelfth Five Year Plan (2012-17), that is, from the financial year 2017-18, States can expect more untied grants and less of tied grants. But the overall size of the grants largely depends on the central tax effort. The Tamil Nadu government projected the share in central tax revenue and grants from the central government at Rs. 23,688.11 crore and Rs. 22,496.08 crore, respectively for the fiscal 2016-17. The total central financial transfers would be roughly 28 per cent of revenue expenditure of the State for the same period.

Given the likelihood of higher subsidies to honour election promises and salary and pension outgo due to the implementation of the Seventh Pay Commission awards, the revenue expenditure of the new government in Tamil Nadu for the year 2016-17 and, quite likely thereafter, should increase substantially.

Given that the outstanding liabilities of the Tamil Nadu government are projected to be around 21 per cent of GSDP in the year 2015-16, it is quite likely that the borrowings to meet these liabilities in the years to come will increase manifold. There is a proposal that the central government shall allow higher level of fiscal deficit – GSDP ratio for States that have not breached the outstanding liabilities–GSDP ratio. In this context, the stipulated outstanding liability–GSDP ratio for Tamil Nadu is 25 per cent, therefore, there is still potential to increase its borrowings in the years to come. The fiscal deficit–

GSDP ratio for Tamil Nadu is fixed at 3 per cent as per the Fiscal Responsibility Legislation of the State. Therefore, in all likelihood Tamil Nadu shall be allowed to increase its fiscal deficit–GSDP ratio beyond 3 per cent till the outstanding liabilities-GSDP ratio reaches 25 per cent. Therefore, it is likely that the new government resorts to larger borrowings from 2016-17.

The inevitability of higher borrowing

Given the compulsion of competitive politics to increase the subsidy bill of the State government, there is every need to be cautious about evaluating the expenditure programmes promised in election manifestoes by parties promising to implement them upon coming to power. Though there is scope to increase OTR of the State government, the political and administrative efficiency to achieve higher level of revenue mobilization through taxes remains a distant dream. The non-tax revenue mobilisation is marred by politics over collecting user charges and inefficiency in running PSUs. The increasing proportion of untied grants comes with declining proportion of overall financial transfers from the central government. This is the most likely feature of central financial transfers in future. Therefore, higher level of borrowing is the only option available for the next government and that would be used to the maximum.

Rationalisation of public expenditure is the real answer to get out of this tricky situation. An example will amplify what the State needs to do. The CAG Report on Local Bodies in Tamil Nadu, reported a case of Vellore City Municipal Corporation (VCMC). On the advice of the State government, the VCMC implemented the 'Amma Canteen' scheme and incurred a loss of Rs. 1.72 crore in 2012-13, whereas against the norm for supply of water at the rate of 135 litres per capita per day (Lpcd), the VCMC could supply only 37 to 45 lcpd to 97 areas, of which 60 areas received water only once in 7 to 11 days. Such misplaced expenditure profligacy will be fiscally disastrous, economically unproductive, and further compromise the role of the state in providing basic goods and services.

<u>Expalantory notes:</u>

1. Unlike committed expenditure, discretionary expenditures can be stopped at any point of time, as there is no contract involved.

2. **Why Gujarat is used as a comparable State?** Any State could have been selected for such a comparison. Every State has a large potential to tax liquor production under State Excise and distribution of liquor under Sales Tax. However, sales tax revenue from liquor trade was not available for any State and it was not possible to compare the tax effort net of tax revenue from liquor across States. Gujarat, being a dry State, has negligible tax revenue from liquor under both State Excise and Sales Tax, hence this comparison. In addition, the structure of economy and level of development are more or less the same in these two States.