

UPDATED VALUE ADDITION MATERIAL 2024
INDIAN ECONOMY

INDIAN ECONOMY AND ISSUES *Relating to* **MOBILIZATION OF RESOURCES**



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CONTENTS

1. Introduction	2	7. Panchayat's Finance	6
2. Sources of Government's Financial Resources	2	7.1. Suggestions to Increase Revenue of Panchayats	6
3. Transfer of Resources from Center to States	3	8. Urban Local Bodies' Finances	7
4. Issues in Mobilization of Resources	3	8.1. Suggestions to Increase Revenue of Urban Local Bodies	7
5. Steps taken by the Government	4	9. Gross Fixed Capital Formation (GFCF) ...	8
5.1. Suggestions to Improve Mobilization of Resources.....	4	9.1. Significance of GCF	8
6. State Finances.....	5	9.2. Challenges	9
6.1. Concerns with State Finances	5	10. Previous Years UPSC Mains Questions ...	9
6.2. Ways to Improve State Finances.....	6	11. Previous Years Vision IAS GS Mains Questions	9

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1. Introduction

Anything that has *utility* or *usability* is a resource. The government requires resources – human, physical and economic - to carry out its functions. In this document, we will deal only with economic resources. Mobilization of resources, in this context, means “**efficient collection and channelizing of resources**” to achieve some goal.

Ways of resource mobilization include direct or indirect taxes, import or export duties or fees for services, or borrowings.

2. Sources of Government's Financial Resources

Mobilization of Resources

The government requires resources – human, physical and economic - to carry out its functions. Here, the reference is only to economic resources. Mobilization of resources, in this context, means efficient collection and channelizing of resources to achieve some goals.

Sources:	Issues:	Steps taken:
• Tax Revenue: Direct & Indirect taxes. • Non-Tax Revenue: Interests on bonds held, Dividends from PSUs, grants etc. • Capital Receipts: Borrowings of the government like the market loans, external commercial borrowings etc., loans received from foreign governments and bodies, disinvestment receipts etc.	• Distribution of financial resources between the centre and the states (vertical imbalance) and among the states (horizontal imbalance). • Fiscal Consolidation: Meeting FRBM targets with regard to fiscal deficit and controlling revenue expenditure. • Low Tax-to GDP ratio: India's tax-to-GDP ratio for 2017-18 was 11.6%, which is well below the emerging market economies' and OECD averages of about 21% and 34% respectively. • Large subsidy budget: Food, Fertilizers and Fuel (3Fs) are major components. • Tax avoidance using various corporate tax exemptions, and tax evasions.	• Doing away with plan and non-plan expenditure. • Merger of General and Railway Budget. • Restructuring of Centrally Sponsored Schemes -Core of the Core, Core and Others. • Rationalization of subsidies through DBT and other initiatives. • Tax augmenting measures such as levy of Long Term Capital Gains tax, Equalization levy, renegotiation of Double Taxation Avoidance Agreements (DTAAs) with various countries etc.

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3. Transfer of Resources from Center to States

In the federal system of India, state and local bodies depend a lot on Center for meeting their financial requirements.

There exist several mechanisms to channel resources from Center to states, such as

-  Finance Commission to lay down principles which shall govern division of sharable pool of taxes of Union of India.
-  Goods and Services Tax Council make the recommendation on rate of the GST, surcharges, Exemptions, Model of GST law, Place of Supply rules, and special rate of the GST, Special Provision for North east states or any other matter as decided by the council.
-  Grants-in-Aid under Article 275 of the Constitution of India.
-  Discretionary grants under Article 282.

4. Issues in Mobilization of Resources

- A.** There exists **vertical imbalance** (between the Centre and the States) and **horizontal imbalance** (among the states with varying fiscal capacities) in the distribution of financial resources.
- B. Fiscal Consolidation:** During 2011-12 to 2019-20, the fiscal deficit of the Union government remained above the FRBM target, although it improved from 5.9 per cent of GDP in 2011-12 to 3.4 per cent in 2018-19. In 2019-20, it again increased to 4.6 per cent and to 9.22 per cent in 2020-21. As it is well known, the sharp increase in the fiscal deficit to GDP ratio for the year 2020-21 is attributed to the sharp decline in revenues due to COVID-19 induced contraction in the economy.
- States have fared better than the Union, in terms of meeting fiscal consolidation targets. Except 2015-17, when the impact of UDAY scheme was pronounced, states have maintained fiscal deficits (aggregate for all states) below 3 per cent of GDP. As per the RE 2020-21 of states, all State fiscal deficit has increased to 4.53 per cent of GDP as against 2.8 per cent (2020-21, BE).
- C. Low Tax-to GDP ratio:-** India's tax-to-GDP ratio for 2023-24 was 11.6% and is well below the emerging market economies and OECD averages of about 21% and 34% respectively. **Key reasons** for India's low tax-GDP ratio are:
- Structural factors such as low per capita income keep tax collections low.
 - Exemptions in the taxable income** have grown at a much faster rate than the income reducing tax buoyancy.
 - A lack of policy initiatives has also kept the tax rate low such as *certain tax exemptions* to income generated by small and medium enterprises and agriculture related activities.
 - Taxpayers accounted for only 2.2% of the voting population in India whereas in the US, more than 50% of voters are taxpayers.
 - Inefficient tax administrative system, arbitrariness in deciding upon tax quantum of corporate, loopholes in Double Taxation Avoidance Agreement, multiple litigations involving corporate etc. have affected the revenue capacity.**
- D.** It is widely known that India's **subsidy system** is highly inefficient and millions of needy people do not get their quota of subsidy. Food, fertilizers and fuel (3Fs) are major components of the union's subsidy budget.

NITI Aayog on rationalizing subsidies:

- Social subsidies should be reoriented so that people become economically independent rather than perpetually dependent upon them.
- Within revenue expenditure, subsidies have crowded out more socially relevant expenditures like education and health.
- Better targeting through use of socio-economic and caste census data.
- Doing away with production subsidies like cheap lands and other benefits to companies.
- Use of DBT in all the social welfare distribution schemes.

- E. Increasing Tax Arrears:** The income tax department has Rs 11.1 lakh crore in tax arrears till 2017-18. The Government should make a determined effort to recover the huge income tax arrears. The total arrears amount to be recovered is stuck because of a variety of reasons like litigation, companies in liquidation, sick companies and untraceable taxpayers.
- F. Corporate Tax Exemptions** – Despite having a scheduled corporate tax rate, which is comparable with developed countries, the effective tax rate for the private corporate sector in India continues to be low due to the myriad exemptions. The various tax exemptions that exist today needs to be rationalized.

5. Steps taken by the Government

- Doing away with plan and no-plan expenditure.
- Merger of General and Railways Budget.
- Restructuring of CSS.
- N K Singh panel was formed to review FRBMA for fiscal consolidation.
- Rationalization of subsidies through several initiatives:
 - Direct Benefit transfer scheme through Jan Dhan-Mobile-Aadhar trinity.
 - Shifting to Nutrient based subsidy scheme for fertilizers.
 - Doing away with fuel subsidies except LPG and Kerosene.
 - Freeing diesel and petrol prices.
 - Give-it-up campaign for LPG subsidy and withdrawing LPG subsidy from consumers having taxable income of 10 lakhs or more
 - One Nation One Ration Card (ONORC) plan
- Review of Public Private Partnership projects (PPPs) through various initiatives:
 - Setting up robust institutional structure for appraising and approving PPP projects.
 - Developing standardised documents such as model concession agreements across infrastructure sectors.
 - Increasing availability of finance by creating dedicated institutions and providing viability gap funding.
 - Abolishing of FPIB as more than 90% of FDI inflows are routed through the automatic route which do not require prior approval of FIPB.
- The government has set up a **National Land Monetisation Corporation (NLMC)** to fast-track the monetisation of land and noncore assets of public sector entities.

5.1. Suggestions to Improve Mobilization of Resources

- **Mobilization of states' revenues:**
 - There is considerable variance in own-revenue mobilization across states, ranging from 5% to 10% of gross state domestic product among major states.
 - The states could improve revenue performance through better tax administration and use of data analytics and other technologies to plug revenue leakages, rationalize tax and user fee structures, and expand the tax base.
- **Private sector resource mobilization:**
 - The National Infrastructure Pipeline of the Government of India includes private capital as a crucial source of financing.
 - There is a need to strengthen capabilities, revenue mobilization plans, and risk-sharing models for public-private partnership, including asset monetization toward mitigating climate change and achieving the Sustainable Development Goals in sectors such as energy, urban, transport and logistics, and health and medical education to attract private sector capital.
 - This includes capacities to utilize real estate investment trusts and infrastructure investment trusts with the government and development agencies at the national, state, and substate levels.

- **Ramping up climate finance:**
 - The Government of India has identified mobilizing international and domestic sources of climate finance, especially lower-cost finance, as a crucial element in its low-carbon development strategy.
 - One of the ways of mobilizing climate finance is green bonds. Climate budgeting is also another important tool for governments to embed climate considerations in the budgeting and monitoring process.
- **Strengthening urban bodies' revenues and fiscal management:**
 - To enhance creditworthiness of ULBs, an integrated approach is required, focusing on increasing their revenues (e.g., property taxes and other own sources revenues); rationalizing expenditures; enhancing efficiencies; and improving governance.
 - Further, strengthening finances of government agencies and parastatal organizations that provide significant urban infrastructure and services is also important for increasing their ability to provide better services.

6. State Finances

Recently, the Reserve Bank of India published an annual report titled "State Finances: A Study of Budget of 2023-24". The theme of the Report is 'Revenue Dynamics and Fiscal Capacity of Indian States'.

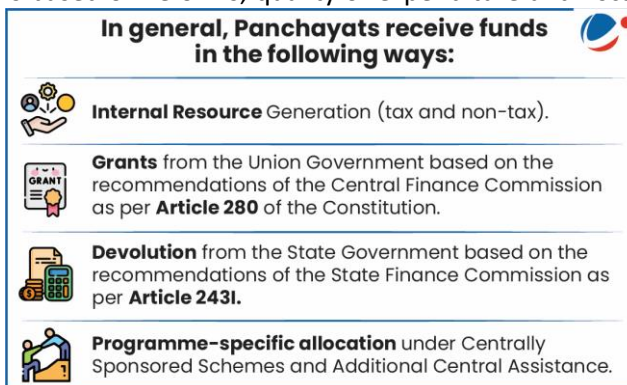
Key Findings	
Category	Details
 GFD-GDP Ratio	◀ Declined from 4.1% in 2020-21 to 2.8% in 2021-22 ◀ Led by moderation in revenue expenditure and increase in revenue collection
 Capital Outlay	◀ Involves expenditure towards asset creation and has a multiplier effect on economic output ◀ Budgeted to increase by 42.6% in 2023-24 to 2.9% of GDP
 States' Total Outstanding Liabilities	◀ Debt-GDP ratio declined from 31% (end-March 2021) to 27.5% (end-March 2023) ◀ Supported by fiscal consolidation, Support from Centre via 50-year interest-free capex loans helped reduce interest burden
 Net Market Borrowings	◀ Declined to 76% in the budgeted GFD for 2023-24 ◀ Decline due to increased loans from the Centre
 Increased Tax Buoyancy	◀ Implementation of GST led to increased tax buoyancy for the States ◀ GST implementation led to greater formalization of the economy, expanding the tax base
 Committed Expenditure	◀ Includes interest payments, administrative services, and pension ◀ Expected to remain at 4.5% of GDP

6.1. Concerns with State Finances

- **Low Non-Tax Revenues Collection:** Non-Tax Revenues remained around 1 per cent of GDP in the last 10 years compared to a ratio of 10 % or more in countries like Singapore, Egypt and Iran.
- **Reduced Development Expenditure:** The allocations for education, sports, art and culture, relief on account of natural calamities, urban development, agriculture and allied activities, and rural development were reduced.
- **Old Pension Scheme (OPS):** Return to the OPS would exert a huge burden on State finances and restrict their capacity to undertake growth-enhancing capital expenditures.
 - If all the State governments revert to OPS from the National Pension System (NPS), the cumulative fiscal burden could be as high as 4.5 times that of NPS.
- **Precarious Fiscal Situation:** Any further provision of non-merit goods and services, subsidies, transfers and guarantees will render their fiscal situation precarious and disrupt the overall fiscal consolidation achieved in the last two years.

6.2. Ways to Improve State Finances

- **Increase Non–non-tax revenue:** Through revisions of user charges on electricity, water and other public services, royalties and premiums from mining, asset monetization etc.
- **Prevent Revenue Loss due to Illegal Mining:** Utilize modern technologies such as Geographic Information Systems (GIS) and Drone Surveys to identify and curb illegal mining activities.
- **Performance-Based Transfers:** Finance Commissions could consider recommending an increased share of conditional transfers based on reforms, quality of expenditure and fiscal sustainability. This will harness healthy competition across States towards improving their economic performance.
 - Currently, revenue deficit grants are disbursed to those States which are assessed to have high revenue deficits post-tax devolution.
- **Increase Fiscal Capacity:** Need for scaling up fiscal capacity for uninterrupted and efficient delivery of social, economic and general services to the people and for upgrading the quality of physical and human capital.
- **Streamlining Fund Transfers for Efficient Governance:** Efficient banking arrangements and cash management practices are essential for the effective utilization of the government's financial resources and the timely execution of payment obligations.
 - Fragmented banking arrangements - multiple accounts maintained by numerous revenue-collecting and spending agencies (including autonomous and statutory bodies) - can result in inefficient cash management practices.
- **Climate finance:** The Centre can introduce performance-based incentives for States that achieve significant progress towards climate goals.



7. Panchayat's Finance

Across the country, States have not given adequate attention to fiscal empowerment of the Panchayats. One can draw the following broad conclusions:

- Internal resource generation at the Panchayat level is weak.
- This is partly due to a thin tax domain and partly due to Panchayats' own reluctance in collecting revenue.
- Panchayats are heavily dependent on grants from Union and State Governments.
- A major portion of the grants both from Union as well as the State Governments is scheme specific.
- Panchayats have limited discretion and flexibility in incurring expenditure.
- In view of their own tight fiscal position, State Governments are not keen to devolve funds to Panchayats.
- Overall, a situation has been created where Panchayats have responsibility but grossly inadequate resources.

7.1. Suggestions to Increase Revenue of Panchayats

In order to widen their tax base the PRIs will need to explore additional sources of revenue.

- Sectors like transport, tourism and infrastructure have grown remarkably and a part of this growth has also percolated to the rural sector.
- Among the classical items of tax collection – imposition of profession tax, cattle registration

fee and vehicle registration fee are the three notable areas which have not been exploited optimally by the Panchayats. The Panchayats need to be more imaginative and assertive in tapping such resources.

- All common property resources vested in the Village Panchayats should be identified and made productive for revenue generation.
- The local community represented by the local Panchayat should have prime right over the income from royalty accrued to the State Government for mining in that area. State Finance Commissions should bear this in mind while finalizing devolution of grants to the rural local bodies. State Governments should consider empowering the PRIs to collect cess on the royalty from mining activities.
- One of the effective and fair tools to improve revenue collection of the local bodies is to **incentivize** their efforts. Panchayats which have shown positive results must be suitably rewarded. This can be done by linking grants and aids from centre and state to their own revenue generation efforts.

8. Urban Local Bodies' Finances

Receipts in case of an urban local body can be broadly classified as follows:



Tax Revenue – property tax, advertisement tax etc.



Non-Tax Revenue – income in terms of rent, royalty, interest, fees and profits/dividends, user charges for public utilities such as water, sewage etc.



Devolution of funds from the State Government



Grants from Union and State Governments for development schemes



Grants from Union and State Governments for development schemes

8.1. Suggestions to Increase Revenue of Urban Local Bodies

- There is lot of scope for improvement in the area of **Property Tax** which is the most important source of revenue for local governments, such as:-
 - **Widening the tax base** – Only 50-60 per cent property is assessed. There are several reasons for low coverage. With urban sprawls, a large number of properties fall outside the legal jurisdiction of the municipal bodies. State laws often provide for exemption to a number of categories of buildings such as those belonging to religious or charitable institutions. A large number of properties belonging to the Union and State Governments are not taxed because of the provisions of **Article 285**. All these properties use services like solid waste management, maintenance of approach roads and general civic amenities. Therefore, Local Governments should be empowered to collect '**service charges**' in respect of these properties.

- **Improving Collection Efficiency – As per CAG report**, the average property tax collection efficiency during 2015-16 to 2019-20 in the ULBs was 53 per cent, while the collection efficiency in Municipal Corporation of Greater Mumbai during the said period was only 28 per cent. Poor data base management, improper upkeep of records, collusion between tax payers and recovery officers and lack of understanding of the tax regime are the main reasons for low recovery rates.
- **Making Property Tax Buoyant** – The tax fixed for a property would remain unchanged till such time an overall revision in the property tax was undertaken in the municipal areas. Such revisions in some places did not take place for several years or even decades. The Unit Area Method overcomes this problem to some extent.
- As per **2nd ARC (Administrative Reforms Commission)** suggestions, following principles in administration of taxes should be followed:-
 - Transparent and objective levy of tax
 - The cost of collection (for local body) and compliance (for tax payer) should be reduced to a minimum
 - An independent unit under the Chief Executive to monitor the collection of all taxes
 - Levies should be based on self-declaration accompanied by stringent penalties.
- The levy and collection of **appropriate user charges** for various services provided by municipality must be encouraged.
- State governments should enact fiscal management laws stipulating upper limits for borrowings where municipalities borrow from the market on the basis of their own rating.
- The institutional capability of municipal bodies needs to be enhanced as a necessary pre-condition for successful PPP projects.
- Land held by municipal bodies should be used as a leverage for raising infrastructure investment by leasing of these lands and also borrowing against the value of these lands.

9. Gross Fixed Capital Formation (GFCF)

The sluggish growth of private Gross Fixed Capital Formation (GFCF) as a percentage of Gross Domestic Product (GDP) at current prices has been a significant challenge for the Indian economy.

Capital formation: It refers to the process by which resources are invested in assets like plants, equipment, machinery, etc. as well as in human capital through education, health, skill development, etc.

Gross Capital Formation (GCF): It refers to the growth in the size of fixed capital in an economy. It includes

- **Gross Fixed Capital Formation (GFCF):** Like land improvements; plant, machinery, and equipment purchases; and the construction of roads, etc.
- **Change in stock (CIS)** of raw materials, semi-finished and finished goods: Stocks of goods held by firms to meet temporary fluctuations in production or sales. o Net acquisition of valuables: like gold, gems, ornaments and precious stones etc.

Net capital formation (NCF) is distinguished from GCF in that NCF includes depreciation, obsolescence and accidental damage to fixed capital.

9.1. Significance of GCF

- **Growth Multiplier:** GFCF and GDP are positively correlated and indicate that an increase in GFCF invariably leads to an increase in GDP.
- **Boosts productivity and living standards:** GFCF helps workers produce a greater amount of goods and services each year, helps boost output and improves living standards.
- **Promotes Self-sufficiency:** Growth in GFCF enables the creation of capital assets, thus improving self-sufficiency in production as well as research in the longer term.

- **Indicator of Market Confidence:** GFCF is considered a meaningful indicator of future business activity, business confidence and future economic growth patterns.
 - For example, Private GFCF can serve as a rough indicator of how much the private sector in an economy is willing to invest.
- **Reflects overall output:** GFCF as an indicator helps to determine the overall output of an economy and hence what consumers can actually purchase in the market.

9.2. Challenges

- Slow pace of reforms especially land acquisition has deterred investors from investing in the economy.
- Financial problems of Indian banks and many large corporations. This indirectly locks the capital available in the market which cannot be reinvested in new projects.
- High cost of borrowing slows down the cycle of lending and borrowing, thus deterring effective channelling of investment.
 - High cost of borrowing stems from higher lending rates, which in turn is affected by high inflation.

10. Previous Years UPSC Mains Questions

1. What is the meaning of the term 'tax expenditure'? Taking housing sector as an example, discuss how it influences the budgetary policies of the government. **(2013)**
2. What were the reasons for the introduction of Fiscal Responsibility and Budget Management (FRBM) Act, 2003? Discuss critically its salient features and their effectiveness. **(2013)**
3. Discuss the rationale for introducing the Goods and Services Tax (GST) in India. Bring out critically the reasons for the delay in roll out for its regime. **(2013)**
4. Craze for gold in Indians have led to a surge in import of gold in recent years and put pressure on balance of payments and external value of rupee. In view of this, examine the merits of Gold Monetization Scheme. **(2015)**
5. Among several factors for India's potential growth, savings rate is the most effective one. Do you agree? What are the other factors available for growth potential? **(2017)**
6. How are the principles followed by NITI Aayog different from those followed by the erstwhile planning commission in India? **(2018)**
7. Enumerate the indirect taxes which have been subsumed in the Goods and Services Tax (GST) in India. Also, comment on the revenue implications of the GST introduced in India since July 2017. **(2018)**
8. Explain the rationale behind the Goods and Services Tax (Compensation to States) Act of 2017. How has COVID-19 impacted the GST compensation fund and created new federal tensions? **(2020)**

11. Previous Years Vision IAS GS Mains Questions

1. ***Audit reports on various development initiatives in India have frequently highlighted inefficiencies in public expenditure. Identifying these inefficiencies, suggest measures that can be taken to address them.***

Approach:

- Introduce by highlighting the need for effective expenditure in India.
- Briefly discuss the inefficiencies in expenditure as highlighted by various reports.
- Mention the steps that can be taken to tackle these inefficiencies.
- Conclude accordingly.

Answer:**Student Notes:**

Effective use of financial resources has been highlighted in the **United Nations Sustainable Development Group (UNDG)** Reference Guide as a critical dimension in the achievement of Sustainable Development Goals (SDGs). Further, in the SDG India Index, NITI Aayog has also recognised that financial resources are a fundamental driver for achieving the SDGs on time.

However, audit reports on various development initiatives and the finances of the Center and states have frequently highlighted inefficiencies in expenditure. **These include:**

- **Persistent non-spending of allocated funds:** The persistent problem of unspent balances is a direct consequence of India's broken governance structures (at various levels), which have been highlighted in various reports. For instance, a CAG report on the Clean Ganga Mission pointed to an unspent balance of approximately Rs. 2500 crores in 2017.
- **Diversion and parking of funds:** The CAG report of 2017 on performance audit of disaster management in Jammu and Kashmir reported that 25 percent of the expenditure meant for disaster mitigation purposes was diverted towards ineligible works.
- **Irregular and wasteful expenditure:** The CAG report in 2020 exposed several irregularities and wasteful expenditures to the tune of hundreds of crores by various Goa government departments.
- **Misallocation/misutilisation of funds:** Welfare schemes such as the Sarva Shiksha Abhiyan, Mid-Day Meal Scheme, PM Awas Yojana, Swachh Bharat Mission, etc. are riddled with misallocation and leakages. A Parliamentary Standing Committee report highlighted the issues of widespread corruption, insufficient funding and huge pending payments for wages in schemes like the MGNREGA.

The Voluntary National Review (VNR) Report and Three Year Action Agenda have listed out several measures for improving expenditure efficiency and effectiveness, which are as follows:

- **Reorientation of the Budget with SDGs:** Preparation of the Outcome Budget mandated since 2006-07 has not been as effective as envisaged and there is a need to reorient the Budget with SDGs. States like Haryana, Maharashtra, Assam etc. have taken some preliminary steps in this regard.
- **Expenditure reforms:** These include the following:
 - Introduction of **sunset clauses** in all public expenditure programmes.
 - Effective utilisation of the **Public Financial Management System** for tracking all expenditure flows.
 - **Rationalisation of schemes** through merger and dropping of overlapping schemes.
 - **Use of technology** like e-procurement and adoption of a Government e-Marketplace (GeM) model etc.
- **Intervention at the stage of formulation of schemes:** The schemes need to be formulated after adequate consultation with the state governments. There should be specific Ministry-wise Councils so that the Ministries formulate schemes in tandem with the existing state schemes for optimum utilization of resources.
- **Need of an expert institution:** The NITI Aayog or a body like the Centre-State Expenditure Commission can give directives and lay down the priorities with respect to expenditure.

In addition, improving efficiency of expenditure would need to be established through suitable audits. Further, a decentralized and local approach can help in achieving efficiency while incurring expenditure.

2. In view of India's rapid urbanisation, it has become imperative to tap into municipal bonds to meet the rising demand of capital investment in urban areas. Discuss.

Approach:

- Give a brief context about the rising fund requirements for upscaling urban infrastructure in India.
- Discuss how municipal bonds can help in this context.
- Write the challenges faced by municipal bonds in India.
- Conclude appropriately.

Answer:

According to the **World Urbanization Prospects, 2018**, more than 50% of India's population will be urban by 2050. By some estimates, India needs to **build a Chicago** every year and is expected to see an influx of population the size of the entire USA into its cities over the next decade. A new **World Bank report (2022)** estimates that India will need to invest **\$840 billion** over the next 15 years—or an average of \$55 billion per annum—into urban infrastructure if it is to effectively meet the needs of its **fast-growing urban population**. Further, the National Infrastructure Pipeline (NIP) envisages Rs. 19 trillion of investments in urban India over a five-year period till FY25.

However, the current urban financing system is plagued with several challenges. For instance, the **devolution of funds** to the Urban Local Bodies (ULBs) from the state is **not predictable and timely**. Further, these devolved funds are largely **tied in nature**, to either **specific sectors or schemes**. The ULBs contribute **only about 1% of India's GDP** as their revenue share often does not rise with the economic growth of an area due to factors like **undervaluation of land** and **limits on taxation power**.

In this context, **successful listing of municipal bonds by more than 10 cities in India** is a silver lining. Most recently, **Vadodara** has raised Rs 100 crore and has also been selected by the US Embassy and Treasury for a case study on **successful listing** and a **benchmark for other civic bodies**.

Significance of municipal bonds:

- **Leverage future cash flows to finance capital expenditure:** As per CARE rating estimates, large Municipalities in India could manage to raise Rs 1000 crore to Rs 1500 crore every year by issuing municipal bonds.
- **Attract new long-term investors and resources into urban projects:** Municipal bonds have been subscribed by insurance funds, mutual funds and external funds that make long-term investments. They also provide greater flexibility in terms of revenue and repayment options.
- **Force multiplier for improving internal processes in ULBs:** Bond route of financing requires ULBs to implement a stringent reporting and disclosure standard, which ushers in greater transparency and accountability towards citizens.
- **Boost the quality of life in cities:** The money raised from municipal bonds can boost the quality of life in cities and enhance job prospects.

Despite its significance, urban financing through municipal bonds cannot be considered as a one stop solution for urban infrastructure financing due to the following reasons:

- **Low credit worthiness:** Out of 94 cities, which are part of the Smart City Mission and AMRUT, only 55 cities got investment grade rating BBB- and above.
- **No insolvency and bankruptcy law for ULBs:** In the event of municipal insolvency or bond default, it is difficult to visualise who will bail out the ULBs.
- **Confidence of investors:** Except in a few big ULBs, **the budgeting and accounting systems lack transparency**, which fails to inspire confidence in the investors. Further, there may be **increased cases of default** when the debts of Municipalities increase, as is happening in China currently.

Thus, municipal bonds can help to pay for vital capital projects—roads, energy, water, sanitation, and other essentials—but there is a requirement of strict implementation of SEBI regulations on municipal bonds, having a specialized agency to protect bond-holders in cases of default (like in Denmark), and adoption of best accounting practices.

3. *Despite the Union Budget 2022-23 being growth-oriented and credit positive, it poses several fiscal challenges. Discuss.*

Approach:

- Discuss how the Union Budget 2022-23 is growth-oriented and seeks investment.
- Mention the fiscal challenges that it poses.
- Conclude accordingly.

Answer:

The **Union Budget 2022-23** was presented in the backdrop of the COVID-19 crisis hitting the economy looking for a turn around. This Budget underscores the government's previous emphasis on capex to sustain a near-term recovery from the pandemic while simultaneously paving the way for longer-term restructuring of the economy.

The Union Budget 2022-23 aims to propel growth and is credit-positive in the following ways:

- **Increase in capital expenditure:** There has been a sharp jump of 35.4 per cent in capital expenditure to fund various infrastructure projects in 2022-23.
- **Boost to infrastructure:** Five big infrastructure projects have been proposed expanding the highways in the country by 25,000 kilometres, Rs 60,000 crore has been allocated to the Har Ghar Jal Scheme (Jal Jeevan Mission), five river linking projects have been announced, Rs 48,000 crore has been allocated to the PM Housing Scheme and there has been a focus on boosting infrastructure development in the North-East through schemes like the PM-DevINE.
- **Digital connectivity:** The Budget announced the auction of 5G spectrum in 2022, proposed setting up 75 digital banking units in 75 districts and brought virtual currencies like cryptocurrency and non-fungible tokens under the tax net.
- **Fiscal prudence:** It has reduced its subsidy budget for food, fertiliser and fuel in the upcoming fiscal by 26.6 per cent. It also projects a narrowing in the Central government deficit to 6.4 per cent of GDP in FY22 from an estimated 6.9 per cent in FY21.
- **Entrepreneurship:** In a move likely to boost investments in startups and make employee stock options (ESOPs) a more lucrative proposition to attract and retain top talent, it proposed to cap the surcharge on long-term capital gains (LTCG) from shares of unlisted companies at 15 percent.

- **Taxation changes:** The securitisation market is to benefit from the changes in the distribution tax for securitisation trusts, as this will improve investors' post-tax returns and make investments in such products more appealing, leading to a new class of investors entering the market.

However, the Union Budget 2022-23 also poses several fiscal challenges:

- **No concrete plans to improve revenue:**
 - The Union Budget lacks tangible measures to increase revenue generation through taxation or other means even though the capital expenditure plans have gone up significantly. Further, the fiscal deficit estimate suggests that the government is relying too much on strong growth to help drive fiscal consolidation.
 - The announced revenue-related measures are aimed at other objectives such as fostering startup innovation, ensuring more equitable treatment for cooperatives and state employees, and promoting tax compliance through simplification.
- **Issues pertaining to public sector banks:**
 - It is credit negative for the public sector banks due to insufficient allocation of capital for the sector, as the government has stuck to the capital infusion roadmap announced last year, budgeting just Rs. 25,000 crore in capital injections next fiscal.
 - Increased recognition and provisioning for non-performing assets (NPAs) will require a corresponding front-ending of capital requirements, which suggests that capital constraints will remain a key credit weakness for public sector banks.
- **Other regulatory challenges:** The issue of high customs duties and non-tariff barriers on basic raw materials, other than steel, such as copper, aluminium, and polymers also remain largely unaddressed in the Budget.

In light of these, the rating agency Moody's indicated that the Budget 2022-23, with emphasis on capital expenditure to support growth, is credit positive for non-financial companies, financial institutions, but poses long-term fiscal challenges for the sovereign.

4. Examine the persisting issues related to fiscal stability of states in India. What measures are needed to address these issues?

Approach:

- Give a brief introduction about the current status of states' fiscal condition.
- Discuss the persisting issues related to their fiscal stability in India.
- Suggest measures that need to be taken in this regard.

Answer:

According to a recent **RBI report**, states like **Punjab, Rajasthan, Kerala, West Bengal, Bihar, Andhra Pradesh, Jharkhand, Madhya Pradesh, etc.** have a high debt burden. The cumulative debt of states has risen from 19.1 percent in 2018-19 to 25.1 percent in 2021-22.

While fiscal stability of states is necessary for sound sub-national fiscal health, there are **persisting issues regarding it. They are as follows:**

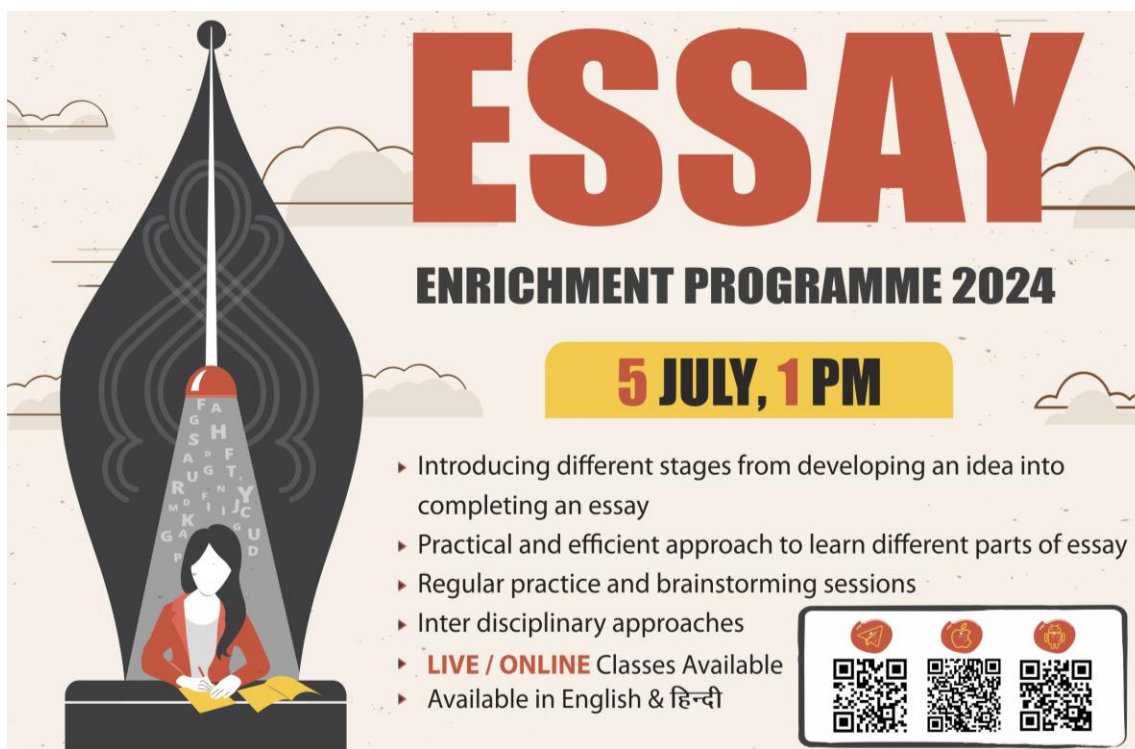
- **Declining revenues of states:** The share of states' own revenue has declined from 69 percent in 1955-56 to below 38 percent in 2019-20 due to slow pace of tax revenue growth. Also, there is a loss of autonomy on tax rates under the GST

regime. Additionally, the COVID-19 pandemic has further impacted the tax revenues of states.

- **High state expenditure:** States have limited fiscal capacity and high share of committed expenditure for socio-economic development and populist measures like farm loan waiver, subsidies, etc. Other committed expenditures include interest payments on debt, pensions and administrative expenses.
- **Implementation of Centrally Sponsored Schemes:** It increases the burden on states to allocate their respective share for these schemes.
- **Contingent liabilities:** Due to the growing trend of using state PSUs, SPVs and other equivalent instruments for off-budget borrowings, the liabilities of states are increasing over time.
- **High DISCOM losses:** High debt levels of DISCOMS have been contributing to the debt burden of states.
- **Legal loopholes:** State governments resort to extra-budgetary borrowings to finance their populist measures and this debt is concealed to circumvent the FRBM target.

Measures that need to be taken for long-term stability of state finances include:

- **Improving fiscal discipline** through expenditure prioritization, debt consolidation and FRBM compliance. The FRBM also needs to be amended to cover all the liabilities of the government.
- **Cap excessive spending and borrowings** at sectoral levels to avoid excessive populism, and their negative spill-overs on other areas.
- **Rationalization of Centrally Sponsored Schemes** to allow more flexibility to states and UTs in their implementation to meet their domestic needs.
- **Raising additional resources** at the sub-national and national levels to increase the tax-to-GDP ratio, which is around 17 percent. Also, there is a requirement of addressing issues on GST compensation continuity, and shrinking of net divisible pool.
- There is a need to **curb the black economy**, as it erodes the fiscal pool of the government and leads to suboptimal spending.



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