

# Discussion Paper

## State Finances

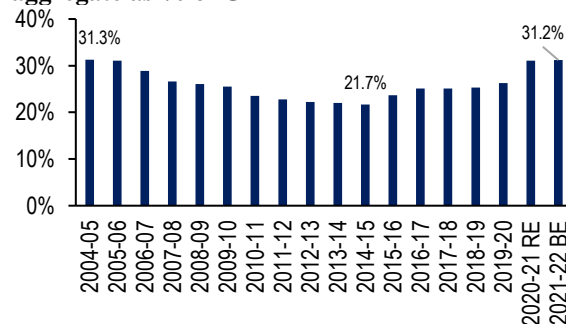
Role of states in government expenditure is increasingly becoming more crucial. In 2022-23, states on aggregate are expected to spend 1.5 times more than the centre. Capital outlay by states in 2022-23 is also estimated to be higher than the Centre. As per the constitutional scheme, states are responsible for providing essential services such as education, healthcare, and sanitation, owing to their proximity to local issues and needs. States also assume an important role in catering to infrastructural needs such as roads, energy, and irrigation. The spending needs of states are partly met by the transfers from the Centre. The debt levels of state governments have seen a sharp increase in recent years.<sup>1</sup> Debt consolidation has been a key tenet of fiscal management in India, owing to higher debt levels as compared to other emerging economies.<sup>2</sup> The overall revenue levels for India have been lower than many comparable economies (about 19.5% of GDP in 2019, as compared to an average of 25% of GDP in emerging market economies, and 34% of GDP in advanced economies).<sup>1,3</sup> This accentuates the need for borrowing to meet the government expenditure. In this light, this note discusses key emerging challenges with the finances of state governments. For a more detailed analysis, please see our [State of State Finances 2022-23](#) Report.

### Debt levels at a historic high

In 2018, the FRBM Act was amended by Parliament to set the debt ceiling for India at 60% of GDP (to be achieved by 2024-25).<sup>4</sup> Of this, the ceiling for the centre was set at 40% of GDP and that for states on aggregate at 20% of GDP.<sup>4</sup> Higher public debt may have adverse implications for investment and growth, as it may lead to distortionary taxes and cuts in developmental spending for servicing the debt.<sup>2</sup>

The dependence on borrowings to fund government expenditure has increased in recent years.<sup>1</sup> This has led to a steep rise in general government debt from about 70% of GDP in 2018-19 to about 89% of GDP in 2021-22.<sup>1</sup> Debt level of states has also followed a similar trajectory. As of March 2022, outstanding

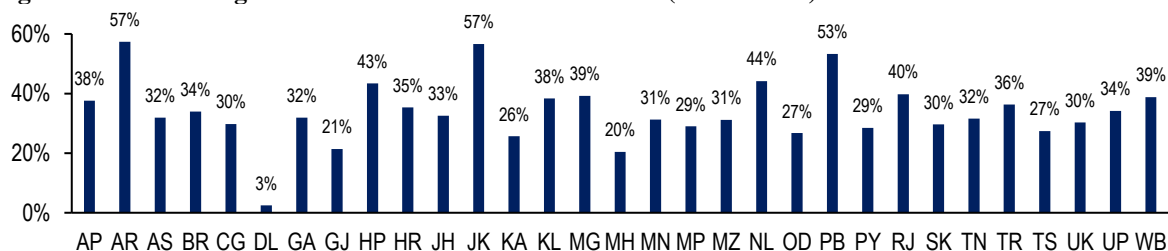
**Figure 1: Outstanding Liabilities of States on aggregate as % of GDP**



Note: RE: Revised Estimates; BE: Budget Estimates.  
Sources: RBI; PRS.

liabilities of states on aggregate are estimated to be 31.2% of GDP, reversing the decline observed in previous years.<sup>5</sup> In 30 states, debt is estimated to be higher than the 20% limit, as of March 2022.

**Figure 2: Outstanding liabilities of states as of March 2022 (% of GSDP)**



Sources: RBI; PRS.

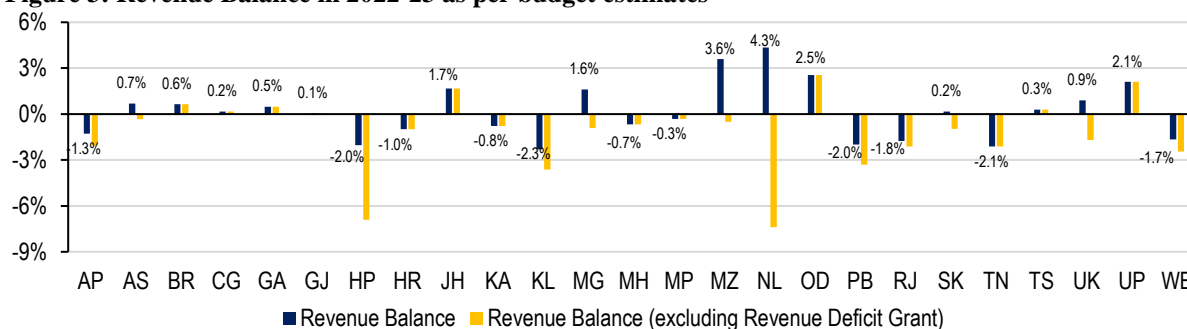
### Many states continue to observe revenue deficit

A long-standing recommendation for fiscal management has been that states should eliminate revenue deficit, i.e., their revenue receipts should be enough to cover their revenue expenditure. Revenue receipts comprise earnings from tax and non-tax sources and central transfers. Revenue expenditure includes expenditure on salaries, pension, interest, and subsidy. A revenue deficit implies that borrowings are needed to fund those expenses which do not lead to the creation of assets or reduction of liabilities. Eight states observed a revenue deficit in all years between 2015-16 and 2019-20: (i) Andhra Pradesh, (ii) Haryana, (iii) Kerala, (iv) Punjab, (v) Rajasthan, (vi) Tamil Nadu, (vii) Uttarakhand, and (viii) West Bengal.

In 2022-23, as per the recommendations of the 15<sup>th</sup> Finance Commission, the central government is estimated to provide a grant of Rs 86,201 crore to states to eliminate the revenue deficit.<sup>1</sup> Seven states are expected to observe a revenue deficit after accounting for the grant. These are Andhra Pradesh, Himachal Pradesh, Kerala, Punjab, Rajasthan, Tripura, and West Bengal. If no such grants were to be provided and expenditure plans were

to hold, six more states would have observed revenue deficit. These are Assam, Meghalaya, Mizoram, Nagaland, Sikkim, and Uttarakhand. Over the next three years, these grants are to substantially reduce. In addition, there are five more states which expect revenue deficit, although they will not receive any grant on this account – Haryana, Karnataka, Maharashtra, Madhya Pradesh, and Tamil Nadu. These states will need to increase revenue receipts or cut back expenditure to manage their revenue deficit level.

**Figure 3: Revenue Balance in 2022-23 as per budget estimates**

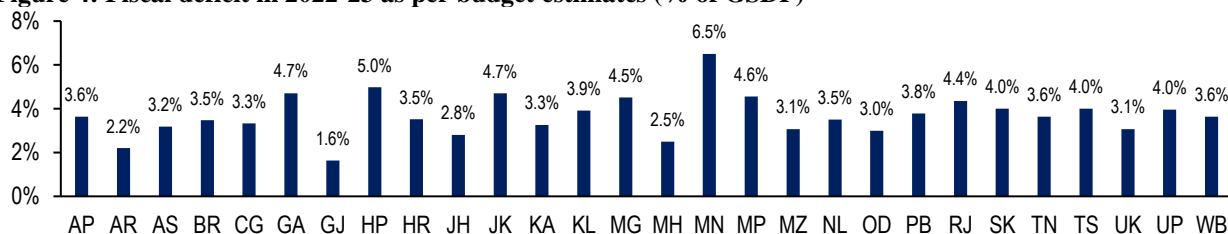


Note: Delhi, Puducherry, and Tripura not shown as 2022-23 GSDP estimates not available for them. Tripura expects a revenue deficit. Higher revenue surplus in Arunachal Pradesh (21%), Jammu & Kashmir (15.1%), and Manipur (15.4%) mainly owing to central transfers. Sources: State Budget Documents; RBI, MoSPI, Report of the 15<sup>th</sup> Finance Commission for 2021-26; PRS.

### Reduction in fiscal deficit limit in coming years may present a challenge for some states

Fiscal deficit is the excess of government expenditure over its receipts. A higher fiscal deficit indicates a higher borrowing requirement in a financial year. In 2022-23, the aggregate fiscal deficit of states is expected to be 3.4% of GSDP. In 2022-23, the fiscal deficit limit has been set at 3.5% of GSDP, as per the recommendation of the 15<sup>th</sup> Finance Commission.<sup>1</sup> An additional borrowing of 0.5% of GSDP is permitted, if a state implements certain power sector reforms.<sup>1</sup> 17 states have estimated their fiscal deficit to be above 3.5% of GSDP in 2022-23. Seven states have estimated their fiscal deficit in 2022-23 to be above 4% of GSDP. From 2023-24 onward, the fiscal deficit limit will be lowered to 3% of GSDP. Additional borrowing of 0.5% of GSDP linked to power sector reforms will be available for two more years – 2023-24 and 2024-25.<sup>1</sup> A reduction in the fiscal deficit limit will require states to recalibrate their expenditure going forward.

**Figure 4: Fiscal deficit in 2022-23 as per budget estimates (% of GSDP)**

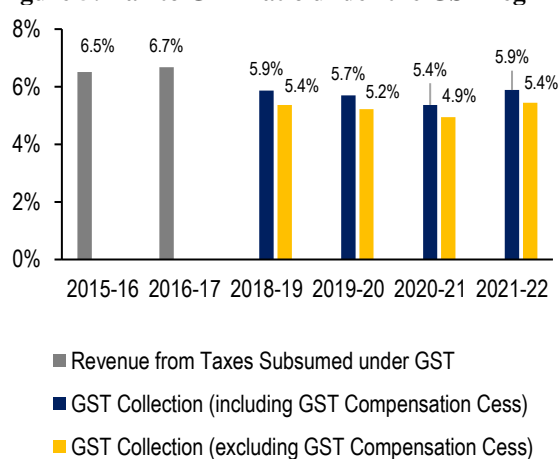


Note: Delhi, Puducherry, and Tripura not shown in the above chart as 2022-23 GSDP estimates are not available for them. Sources: State Budget Documents; PRS.

### Revenue collection under GST continues to be lower than the pre-GST regime

More than 70% of GST revenue accrues to state governments, owing to earnings from SGST, and the devolution of CGST.<sup>1</sup> SGST is estimated to comprise about 42% of the own tax revenue of states in 2022-23. Thus, GST is the most crucial source of tax revenue for states. In 2016-17, the revenue from taxes subsumed under GST was 6.7% of GDP. Revenue collected under GST has been lower than this level so far. Reasons for lower GST revenue level include: (i) a decline in the effective tax rate (from 14.4% in 2017 to 11.6% in 2019), a revenue-neutral rate for GST was recommended to be 15%-15.5%, (ii) economic slowdown between 2018-19 and 2020-21, and (iii) inverted duty structure (higher tax on inputs than finished products), leading to large refunds through input tax credit and less than expected net tax collections for the government<sup>1,6,7</sup> The 15<sup>th</sup> Finance Commission has estimated a potential for GST-to-GDP ratio of 7% over the medium term (net of revenue from compensation cess).<sup>1</sup>

**Figure 5: Tax to GDP ratio under the GST regime**

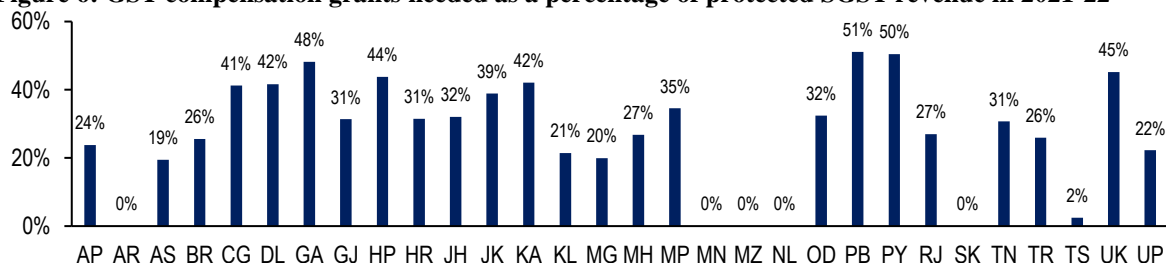


Note: Tax-to-GDP for 2016-17 does not include Arunachal Pradesh, Gujarat, and Haryana due to the unavailability of data. The chart excludes 2017-18 as GST was introduced for part of the year. Sources: GST Network; Union Budget Documents; MoSPI; PRS.

### Dependence on GST compensation grants for revenue

The introduction of GST posed a risk of revenue uncertainty for states. This concern was addressed by guaranteeing states a 14% compounded annual growth in their GST revenue for five years (between July 2017 and June 2022). Any shortfall in a state's GST revenue from this level was covered by the centre by providing compensation grants to the state. The central government levies a GST compensation cess to provide for these grants. The last full financial year for which this grant was available was 2021-22. In 2021-22, for 15 states, the need for GST compensation grants was more than 30% of the protected revenue. Discontinuation of grants may significantly impact the revenue level in these states.

**Figure 6: GST compensation grants needed as a percentage of protected SGST revenue in 2021-22**

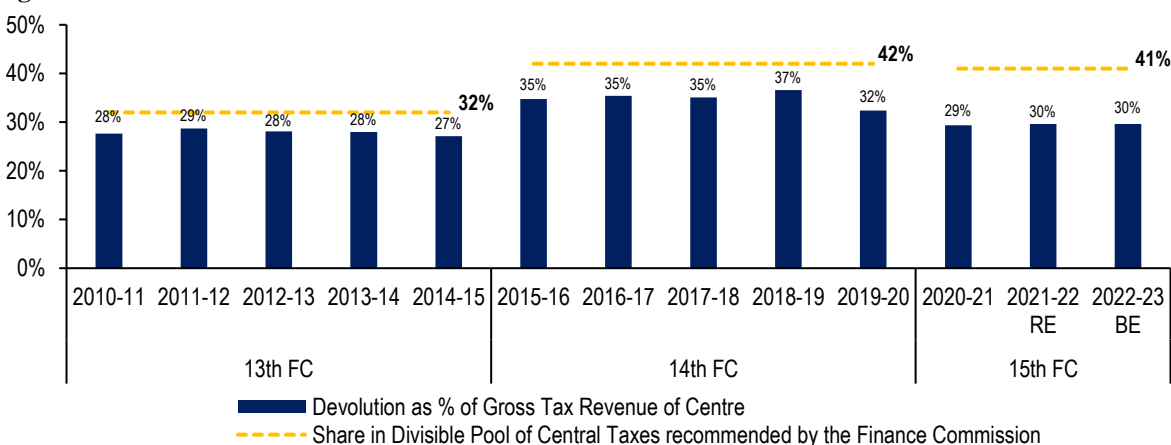


Note: For AP, BR, DL, GA, KA, PY, and UP, compensation needs calculated based on revised estimates from the budget. For the rest, compensation needs have been calculated based on provisional accounts from CAG.  
Sources: GST Council; State Budget Documents; CAG; PRS.

### States' share in central taxes has seen a decline as compared to the recommended level

The 14<sup>th</sup> Finance Commission had observed that tax devolution should be the primary route of the transfer of resources to states, and had termed this principle to be conducive to sound fiscal federalism.<sup>8</sup> Funds from devolution are untied and can be spent as per own priorities. For the 2021-26 period, the 15<sup>th</sup> Finance Commission has set the share of states in the divisible pool of central taxes at 41%.<sup>1</sup> Divisible pool is arrived at after excluding the cost of tax collection, and cesses and surcharges from the gross tax revenue collected by the central government. Due to an increase in the incidence of levy of cesses and surcharges by the central government in recent years, the devolution to states as a share of gross tax revenue has seen a notable decline.<sup>7</sup> In 2022-23, states' share in central taxes is estimated to be 30% of the gross tax revenue of the centre.

**Figure 7: Devolution as % of Gross Tax Revenue**



Note: BE: Budget Estimates; RE: Revised Estimates.  
Sources: Union Budget Documents; PRS.

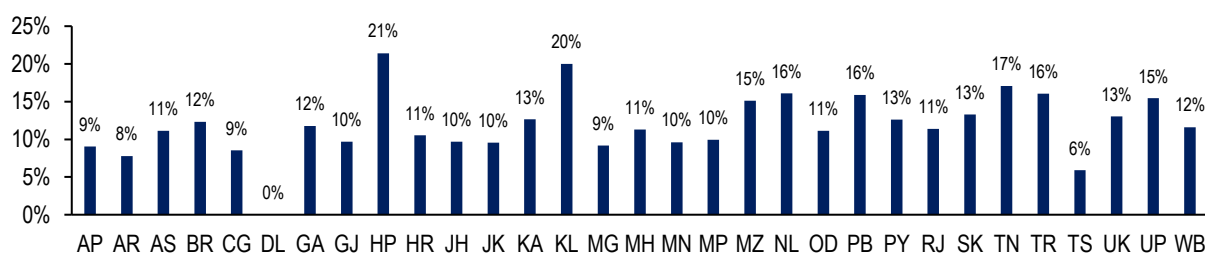
As per the estimates of the 15<sup>th</sup> Finance Commission, overall central transfers are to remain at a similar level during the 2021-26 period when compared to the 2015-20 period.<sup>1</sup> However, the share of grants in transfers is expected to be higher.<sup>1</sup> Grants are often purpose-specific and have conditionalities attached to them.<sup>1</sup> For example, grants for centrally sponsored schemes, which would constitute about 27% of the total transfers in 2022-23, have to be spent on schemes and purposes determined by the centre. It has been observed that states with higher per capita income are able to take better advantage of conditional transfers, due to better fiscal and institutional capacity to meet such conditions.<sup>1</sup> This goes against the emphasis on equity in transfers determined by the recommendations of the Finance Commission (higher transfers to poorer states for convergence).<sup>1</sup>

### High committed expenditure levels and rollback of pension reforms

States spend about 85% of the budget on revenue expenditure items. A large part of revenue expenditure remains inflexible in nature, i.e., they may not be rationalised in short run. In 2022-23, states have estimated to spend 54% of their revenue receipts towards three items — interest (12%), pension (13%), and salaries (29%). A larger proportion of budget allocated for such committed expenditure crowds out developmental expenditure.

Pension payments of states had increased from 2% of revenue receipts in 1980-81 to 11% in 1999-2000.<sup>9</sup> The Report of the Group to Study the Pension Liabilities of the State Governments (2003) had observed that the continuation of the existing pension scheme without any modification would be unsustainable and deteriorate states' financial position.<sup>9</sup> This led to a shift from the old pension scheme (defined benefit) to the new pension scheme or NPS (contribution-based) around 2004-05. Rajasthan, Chhattisgarh, Punjab, and Jharkhand have announced that they will re-implement the defined-benefit-based old pension scheme.<sup>10,11,12,13</sup> There may not be any significant impact of this change on pension expenditure in the short term. Pension expenses may even be lower, as the government contribution for current employees need not be paid anymore. However, when the employees, who joined after the implementation of NPS, begin to retire from 2034 onwards, the costs of reverting to the old pension scheme will become more visible.<sup>14</sup> Adoption of the old pension scheme is expected to benefit the current generation at the cost of future generations.<sup>14</sup>

**Figure 8: Spending on pension and retirement benefits as percentage of revenue receipts in 2022-23**



Note: Figures are as per budget estimates. In case of Delhi, the central government mostly bears the pension liabilities.

Sources: State Budget Documents; PRS.

### Poor financial health of discoms continues to pose risks to state finances

Power distribution in most states is through either state-owned distribution companies (discom) or power departments. These power utilities have continued to make losses (Rs 2.9 lakh crore between 2017-18 and 2020-21), which has required state governments to provide various types of support.<sup>15</sup> The liabilities of these discoms are contingent liabilities of the state government, and the burden of its servicing will fall on the state government if the discom itself is unable to. Thus, the poor financial situation of discoms may pose risks to the finances of state governments. As of March 2021, the outstanding debt of distribution utilities was Rs 5.9 lakh crore, about 3% of the national GDP.<sup>15</sup> Note that to incentivise power sector reforms, additional borrowings of 0.5% of GSDP have been permitted to states between 2021-22 and 2024-25.<sup>1</sup>

<sup>1</sup> Volume-I, Report of the 15th Finance Commission for 2021-26, February 2021,

[https://fincomindia.nic.in/writereaddata/html\\_en\\_files/fincom15/Reports/XVFC%20VOL%20I%20Main%20Report.pdf](https://fincomindia.nic.in/writereaddata/html_en_files/fincom15/Reports/XVFC%20VOL%20I%20Main%20Report.pdf).

<sup>2</sup> Volume-I, FRBM Review Committee Report, January 2017,

<https://dea.gov.in/sites/default/files/Volume%20I%20FRBM%20Review%20Committee%20Report.pdf>.

<sup>3</sup> Fiscal Monitor, International Monetary Fund, <https://data.imf.org/?sk=77413f1d-1525-450a-a23a-47aeed40fe78&sid=1393552803658>.

<sup>4</sup> Fiscal Responsibility and Budget Management Act, 2003, <https://www.indiacode.nic.in/bitstream/123456789/2064/1/A2003-39.pdf>.

<sup>5</sup> Statement 20: Total Outstanding Liabilities-As % of GSDP, State Finances: A Study of Budgets of 2021-22, Reserve Bank of India, November 2021, <https://rbi.org.in/Scripts/AnnualPublications.aspx?head=State%20Finances%20:%20A%20Study%20of%20Budgets>.

<sup>6</sup> Report on the Revenue Neutral Rate and Structure of Rates for the Goods and Services Tax (GST), December 2015,

<https://gstcouncil.gov.in/sites/default/files/CEA-rpt-nrr.pdf>.

<sup>7</sup> State Finances, A Study of Budgets of 2019-20, Reserve Bank of India, September 2019,

<https://rbiidocs.rbi.org.in/rdoc/Publications/PDFs/STATEFINANCE201920E15C4A9A916D4F4B8BF01608933FF0BB.PDF>.

<sup>8</sup> Report of the 14th Finance Commission for 2015-20,

[https://fincomindia.nic.in/writereaddata/html\\_en\\_files/oldcommission\\_html/fincom14/others/14thFCReport.pdf](https://fincomindia.nic.in/writereaddata/html_en_files/oldcommission_html/fincom14/others/14thFCReport.pdf).

<sup>9</sup> Report of the Group to Study the Pension Liabilities of the State Governments, Reserve Bank of India, October 2003,

<https://rbiidocs.rbi.org.in/rdoc/PublicationReport/Pdfs/51177.pdf>.

<sup>10</sup> Order regarding RCS (Contributory Pension) Rules, 2005, Government of Rajasthan, May 19, 2022,

<https://finance.rajasthan.gov.in/PDFDOCS/RULES/10755.pdf>.

<sup>11</sup> Chhattisgarh Budget Speech 2022-23, [https://finance.cg.gov.in/budget\\_doc/2022-2023/Budget-Speech/Budget-Speech.pdf](https://finance.cg.gov.in/budget_doc/2022-2023/Budget-Speech/Budget-Speech.pdf).

<sup>12</sup> "Punjab Cabinet, Led By CM, Gives Nod to Issue Notification for Implementing the Old Pension Scheme in the State, Directorate of Information and Public Relations, Punjab, November 18, 2022, <http://diipunjab.gov.in/?q=content/punjab-cabinet-led-cm-gives-nod-issue-notification-implementing-old-pension-scheme-state>.

<sup>13</sup> Important decisions taken in the meeting of the Council of Ministers held on 15 July 2022,

[http://prdjharkhand.in/iprd/view\\_press\\_release\\_photo.php?prid=31240](http://prdjharkhand.in/iprd/view_press_release_photo.php?prid=31240).

<sup>14</sup> State Finances: A Risk Analysis, Reserve Bank of India Bulletin, June 2022,

<https://rbiidocs.rbi.org.in/rdoc/Bulletin/PDFs/6STATEFINANCESARISKANALYSIS143105EB27A744E1B9C404CF7D96909A.PDF>.

<sup>15</sup> Performance of Power Utilities 2020-21, Power Finance Corporation, September 2021,

[https://www.pfcindia.com/DocumentRepository/ckfinder/files/Operations/Performance\\_Reports\\_of\\_State\\_Power\\_Utilities/Report%20on%20Performance%20of%20Power%20Utilities%202020-21%20\(1\).pdf](https://www.pfcindia.com/DocumentRepository/ckfinder/files/Operations/Performance_Reports_of_State_Power_Utilities/Report%20on%20Performance%20of%20Power%20Utilities%202020-21%20(1).pdf).

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