STATE OF STATE FINANCES

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States have limited flexibility on their revenue after the implementation of GST

Levying GST on petroleum products at current structure may lead to loss in revenue

Fiscal pressure on some states due to seventh pay commission and farm loan waivers

This report covers 26 of the 29 states and the Union Territory of Delhi. These states together comprise 98% of the total budgets of all states, and contain 99% of India's population. The states not included are Arunachal Pradesh, Manipur, and Meghalaya, as we were unable to obtain their detailed budget documents for the last eight years (2011-12 to 2018-19).

The following abbreviations are used for the states in the charts throughout the report.

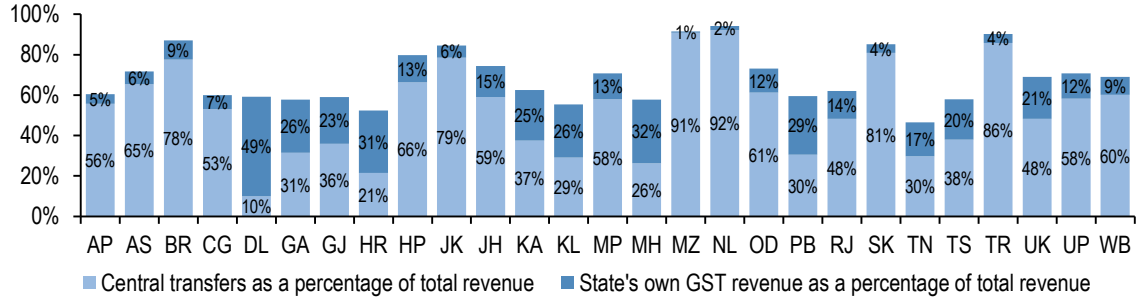
State	Abbreviation	State	Abbreviation	State	Abbreviation
Andhra Pradesh	AP	Jammu & Kashmir	JK	Punjab	PB
Assam	AS	Jharkhand	JH	Rajasthan	RJ
Bihar	BR	Karnataka	KA	Sikkim	SK
Chhattisgarh	CG	Kerala	KL	Tamil Nadu	TN
Delhi	DL	Madhya Pradesh	MP	Telangana	TS
Goa	GA	Maharashtra	MH	Tripura	TR
Gujarat	GJ	Mizoram	MZ	Uttarakhand	UK
Haryana	HR	Nagaland	NL	Uttar Pradesh	UP
Himachal Pradesh	HP	Odisha	OD	West Bengal	WB

KEY INSIGHTS

In 2018-19, states are expected to spend 72% more than the central government, a significant change from 46% in 2014-15 (last year of the 13th Finance Commission). Thus, much of the expenditure that affects citizens is decided at the level of the state. Meanwhile, decisions on receipts are getting centralised at the level of the centre with the implementation of the GST. In this report, we discuss recent developments that affect finances of the states as well as the trends in the last eight years.

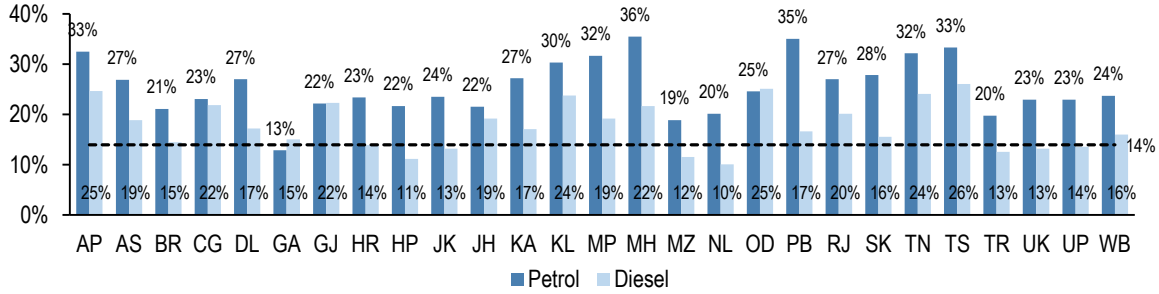
- **GST reduces states flexibility on their receipts:** In 2018-19, transfers from the centre are estimated to make 48% of states' revenue. With implementation of GST (tax rates decided by the GST Council), the autonomy of states is expected to reduce on an additional 17% of their revenue. That is, the decision-making power of states will be limited to 35% of their revenue (page 2). However, several states have seen a boost in revenue as the centre has guaranteed 14% annual growth on the taxes subsumed by GST for a period of five years.

Figure 1: Implementation of GST is expected to reduce the autonomy of states on their revenue (2018-19)



- **Loss of revenue with GST on petroleum products:** The GST Council has the mandate to decide when to include petroleum products within the purview of GST. Given the possibility of reduction in tax rates from the existing higher rates (over 20% sales tax in 25 states and about 24% excise duty on petrol), combined with the availability of input tax credit, there could be significant revenue loss for many states when these products are included under GST (page 3).

Figure 2: Effective sales tax/VAT rates levied by states on petrol and diesel (as on November 1, 2018)



- **15th Finance Commission:** When recommending the criteria for devolution of central taxes to states for the period 2020-25, the 15th Finance Commission will use population data of 2011, instead of 1971 data. This could reduce the share of some states that have made efforts for population control. However, such reductions could be mitigated through incentives for reducing population growth. The Commission will also examine the necessity of revenue deficit grants, impacting states that depend on them to finance their revenue expenditure (pages 4 and 5).

- **Implications of the 7th Pay Commission:** Some states have implemented pay hikes after the 7th Pay Commission increased pay and allowances for central government employees. This has increased their revenue expenditure by 25% in 2017-18, therefore impacting the fiscal balance of these states. Other states may also see a spike in their expenditure if they follow suit (page 6).

- **Impact of agricultural distress:** Farm distress has led to declaration of farm loan waivers by eight states, amounting to Rs 1,77,241 crore. Borrowings of such states can increase due to these waivers. Further, the sugar sector is under stress with dues of sugarcane farmers pending with many mills; if states prepare a rescue package, it will increase fiscal pressure on states (page 7).

DEVELOPING THEMES IN FINANCES OF STATES

States to have limited flexibility on 65% of their revenue with the implementation of GST

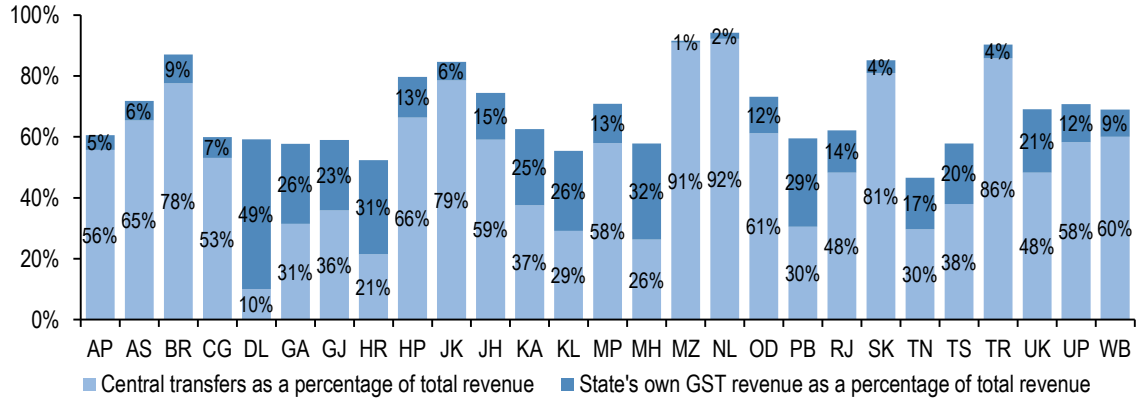
States primarily depend on two sources for their revenue – their own revenue and central transfers. The former indicates revenue generated by states on their own, while the latter consists of receipts from devolution of union taxes and grants-in-aid from the centre. In 2018-19, 52% of the revenue receipts of states is estimated to come from their own revenue, and the remaining 48% of the revenue in the form of transfers from the centre. Since central transfers are outside the jurisdiction of the states, they do not have the authority to make decisions regarding a significant part of their revenue.

With the introduction of GST, many indirect taxes levied by the states have been replaced. While these taxes were completely under the control of each state, GST rates are now decided by the GST Council. This implies that states have limited flexibility in making decisions regarding tax rates on goods and services. Therefore, higher reliance on GST receipts for revenue reduces states' autonomy, as these receipts depend on tax rates decided by the GST Council. Though GST limits the flexibility of states, the centre's guarantee of 14% annual growth in this tax revenue, for a period of five years, has boosted states' revenue. In case of less than 14% growth, states will receive compensation from the centre. In 2018-19, 15 states expect to receive such compensation grants (see Box 1 on page 16).

GST revenue of a state can be categorized into three components: (i) state's own GST revenue, (ii) devolution of centre's GST revenue, and (iii) compensation, if any. While the first component comes under state's own revenue, the other two components form a part of central transfers. In 2018-19, central transfers are estimated to make 48% of states' revenue. With the implementation of GST, the autonomy of states is expected to reduce on an additional 17% of their revenue. This revenue is estimated to come from their own GST revenue (with rates being decided by the GST Council). Thus, effectively, states' have limited decision-making powers on generation of 65% of their revenue.

Across states, the figures vary (Figure 3). The dependence on these sources is more than 85% of the revenue in the case of Bihar, Jammu and Kashmir, and the north-eastern states (except Assam). However, this is more so because of their significantly higher reliance on central transfers. States which have witnessed comparatively larger limitations on their flexibility because of more reliance on GST for their own revenue include Delhi, Haryana, Maharashtra, and Punjab. For instance, Maharashtra has limited control over 26% of its revenue, which comes from central transfers. Further with GST, the state's control will get limited on an additional 32% of its revenue, stretching it to 58%.

Figure 3: Implementation of GST is expected to reduce the autonomy of states on their revenue (2018-19)



Note: State's own GST revenue comes from the levy of SGST, and its 50% share of the IGST revenue. Rest of the IGST revenue and the revenue generated by levying CGST is devolved by the central government, as per the recommendations of the 14th Finance Commission.
Sources: State Budget Documents; PRS.

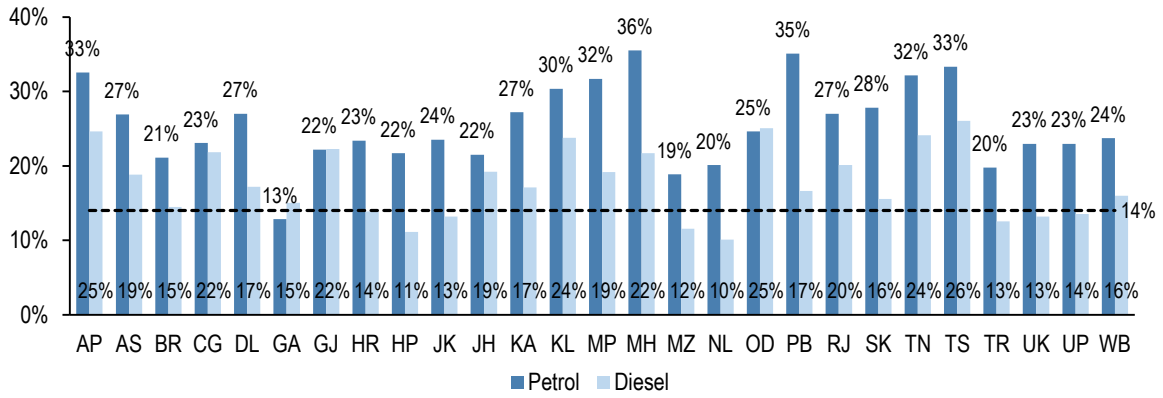
Since the 2018-19 budgets are the first to be presented after the introduction of GST in July 2017, there is lack of uniformity in budget documents across states on reporting individual GST components, especially compensation. For instance, some states have included compensation in their tax revenue, such as Andhra Pradesh and Gujarat, where as some have shown it as central grants, such as Bihar and Karnataka. For uniformity, we have considered compensation as a part of central grants, and thus have adjusted own tax revenue and central grants of some states.

Levying GST on petroleum products at current structure may lead to significant loss in revenue

At present, petrol and diesel are not within the GST structure. Instead, they are subjected to excise duty, levied by the centre, and sales tax/value added tax (VAT), levied by the states. In addition, some states also levy additional surcharge/cess. Petroleum products are used as inputs for production or supply of other goods and services. Excluding them from GST results in cascading of taxes. The GST Council is mandated to recommend the date from which GST will subsume the existing taxes on these products. While this could resolve the issue of cascading of taxes, it may have an adverse impact on the revenue of states. Assuming petrol and diesel are taxed at the highest slab of 28% plus cess, with no additional levies, SGST and CGST would be levied at 14% each, with additional cess.

In the current scenario, 25 out of 27 states levy effective sales tax/VAT of 20% or more on petrol (Figure 4). With levy of SGST at 14%, the state tax rate on petrol will reduce to half or more of the currently effective rate for seven states, reducing the resulting revenue earned from it. For example, currently, Maharashtra effectively levies 36% VAT on a litre of petrol. In comparison, with levy of GST at present rates, it would generate revenue by levying 14% SGST, which is 22 percentage points lower than the present rate. In the case of diesel, this reduction would range from 5%-12% for 11 states. As a result, states could witness large reductions in their own tax revenue.

Figure 4: Effective sales tax/VAT rates levied by states on petrol and diesel (as on November 1, 2018)



Note: The rates shown for Maharashtra are averages of the rates levied in Mumbai-Thane region and the rest of the state.
Sources: Petroleum Planning and Analysis Cell, Ministry of Petroleum and Natural Gas; PRS.

In addition to sales tax revenue, states also receive excise duty revenue from taxation of petroleum products. 42% of the excise duty revenue generated by the centre is devolved to the states as per the recommendations of the Finance Commission. At present, excise duty is levied on petrol and diesel at Rs 9.98/ litre and Rs 5.83/ litre, respectively.[1] Note that this excludes the road and infrastructure cess[*] of Rs 8/ litre, whose revenue is not shared with the states. These excise duty rates, calculated on the base price paid by oil companies for petrol and diesel[†], are about 24% and 12%, respectively. Thus, if GST is levied on petrol and diesel, centre's revenue would come from a levy of 14% CGST, which is ten percentage points lower than the present rate in case of petrol. In the case of diesel, there would be an increase of two percentage points. This will reduce the overall divisible pool of centre's tax revenue generated from petroleum products, and thus, will affect each state's devolution receipts.

Also, when petroleum products are brought under GST, input tax credit will be allowed on the supply of these products. Input tax credit is given to suppliers for the taxes paid by them on the inputs that they have used in the course of their business (and not for self-consumption). At present, suppliers (such as transport operators or industries that use diesel to generate electricity), who pay taxes on the petroleum products that they use as inputs, are unable to claim the benefits of input tax credit on these products. As a result, the government need not refund the taxes that suppliers have paid on petroleum products used in the course of their business. When GST is levied on these products, taxpayers will be eligible to receive input tax credit, which might increase the loss to the exchequer.

[*] Union Budget 2018-19 increased the cess on petrol and diesel by Rs 2/ litre and cut the excise and customs duty by the same amount.

[†] Base prices correspond to the prices in Delhi as on October 29, 2018 (Source: Indian Oil Corporation Limited).

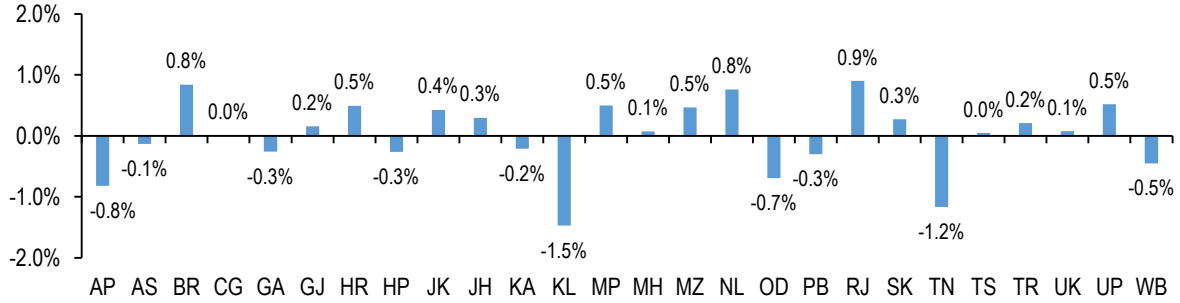
Use of 2011 population by 15th Finance Commission could alter devolution share of some states

The Finance Commission recommends the criteria for determining the share of states in the union pool of tax revenue. The 15th Finance Commission will make its recommendations for the 2020 to 2025 period.[2] The Terms of Reference (ToR) of the Commission mandate the use of population data of 2011 for its recommendations. The ToR also includes proposing performance-based incentives for states to reward the progress made by them in moving towards replacement rate of population growth.

While making its recommendations for the 2015 to 2020 period, the 14th Finance Commission assigned 17.5% weightage to the population parameter, for which it used the 1971 population data, as mandated by its ToR.[3] The ToR also stated that the Commission might also take into account the demographic changes since 1971. Accordingly, the Commission gave 10% weightage to 2011 population data to reflect the demographic changes since 1971. Regarding the data to be used for the population parameter, the 14th Finance Commission observed that though the use of dated population data is unfair, it was bound by its Terms of Reference to use the 1971 population.[3] The states' share in net proceeds of union taxes and duties is estimated to be Rs 7,68,413 crore in 2018-19. This would be allocated to the states as per the 14th Finance Commission's criteria.

To understand the effect of the use of 2011 population data, the revised shares of states have been calculated by changing the population data in the devolution formula used by the Commission. All other parameters, their data, and their weightages remain the same for the purpose of this analysis. The revised criteria will indicate the possible effect on devolution to states in 2018-19, had the 14th Finance Commission used 2011 population data instead of 1971 population data. Figure 5 shows the calculated changes in states' estimated devolution receipts (as a percentage of their revenue) in 2018-19 if 2011 population data were used by the 14th Finance Commission for recommending the criteria.

Figure 5: Changes in estimated 2018-19 devolution receipts (as a percentage of revenue) on use of 2011 population data by the 14th Finance Commission



Note: Calculations do not take into account any adjustments to be made in 2018-19 for the previous financial years. Delhi has not been taken into consideration as it does not have any share in the net proceeds of taxes devolved to states.
Sources: Union Budget Documents; State Budget Documents; Census 2011; Report of the 14th Finance Commission; PRS.

The receipts of some states see comparatively higher change as compared to the others. While Tamil Nadu, Kerala, and Andhra Pradesh see a decrease in their receipts, those of Uttar Pradesh, Rajasthan, and Bihar will increase. This increase as a percentage of 2018-19 estimated revenue would have been 0.5% for Uttar Pradesh (Rs 1,810 crore), 0.9% for Rajasthan (Rs 1,364 crore), and 0.8% for Bihar (Rs 1,329 crore). The decreased receipts would have reduced the revenue by 1.2% for Tamil Nadu (Rs 2,051 crore), 1.5% for Kerala (Rs 1,513 crore), and 0.8% for Andhra Pradesh (Rs 1,276 crore).

With the 15th Finance Commission's mandate to use the population data of 2011 for its recommendations, the share of individual states in the union pool of taxes could see changes similar to the changes calculated for 2018-19 (Figure 5). This could reduce the share of some states which have made efforts for population control, and as a result, the proportion of their population in the total population has reduced since 1971. Thus, such states, e.g. Tamil Nadu, Kerala, and Andhra Pradesh, could witness a comparative reduction in their devolution receipts on similar lines. However, note that, in this analysis, we have not factored in any mitigating factor, such as the performance-based incentives that can be proposed by the 15th Finance Commission to reward such states for population control. Such incentives could mitigate the reduction in devolution to these states because of use of the population data of 2011 (instead of the 1971 population data), as illustrated above.

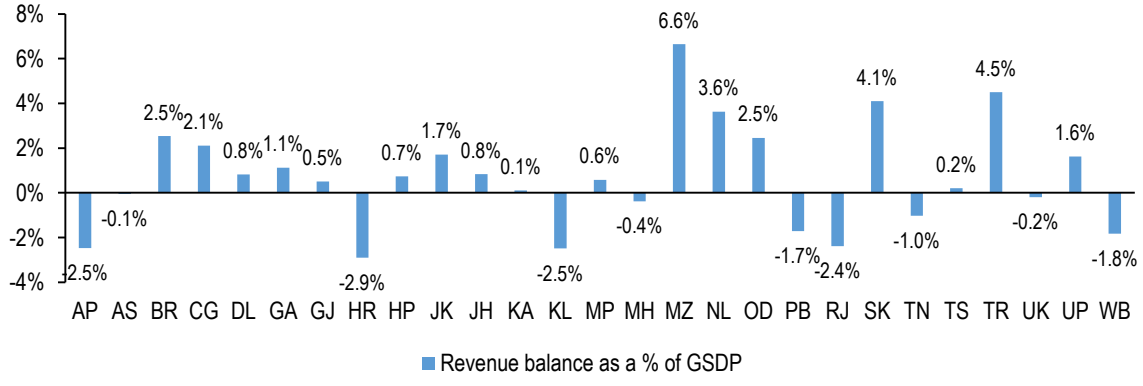
Elimination of revenue deficit grants by 15th Finance Commission could impact some states

One of the Terms of Reference of the 15th Finance Commission is to examine whether revenue deficit grants are required to be provided to states. Revenue deficit is the excess of revenue expenditure (such as spending on salary and interest payments) over revenue receipts (such as taxes and fees received from providing services like state transport and education) of the government. A revenue deficit means that states need to borrow to meet their recurring expenses, which do not create any assets. As per latest available actual figures (2016-17), 17 out of 27 states have eliminated revenue deficit and are revenue surplus states. A revenue surplus implies that the revenue of states is sufficient to meet their expenditure requirements in a given year. A high revenue surplus indicates that a state can: (i) create capital assets; or (ii) pay down outstanding liabilities. The revenue surplus is high in the case of some north-eastern states such as Mizoram, Nagaland, Tripura, and Sikkim and hill states such as Jammu and Kashmir. This is mainly due to the large share of central transfers in their revenue receipts.[3] The revenue surplus in other states can be attributed to augmentation of their own resources and reduction in expenditure by the state.

The 13th Finance Commission had recommended that a long term and permanent target for states should be to maintain a zero revenue deficit.[4] It had prescribed Kerala, Punjab, and West Bengal to eliminate their revenue deficits by 2014-15 (the end of the 13th Finance Commission period). All other states were expected to eliminate their revenue deficit by 2011-12 or earlier. The 14th Finance Commission reiterated this in its recommendation that states should eliminate revenue deficit by 2019-20 (the end of the 14th Finance Commission period).[3] It had observed that seven states, including Andhra Pradesh, Himachal Pradesh, Jammu and Kashmir, Manipur, Mizoram, Nagaland, and Tripura, would need revenue deficit grants to cover their revenue expenditure requirements for the period 2015-16 to 2019-20. The Commission also noted that in addition to these seven states, Assam and West Bengal would need revenue deficit grants for two years, Kerala for three years, and Meghalaya for four years. To derive these revenue deficit grants, the Commission took into account the differences among the fiscal capacity and expenditure needs of states, and the need for states with low average per-capita expenditure to enhance their expenditure.

In 2016-17 (the latest year for which the actual figures are available), 10 states have registered revenue deficit (Figure 6). Haryana has the highest revenue deficit, followed by Andhra Pradesh, Kerala, and Rajasthan. Other states with revenue deficit include Punjab, Tamil Nadu, and West Bengal. Note that among these 10 states, only four states (Andhra Pradesh, Assam, Kerala, and West Bengal) have been given revenue deficit grants by the 14th Finance Commission.

Figure 6: 17 out of 27 states have eliminated revenue deficit (2016-17)



Note: Data for Tripura corresponds to 2015-16 as data for 2016-17 was not available. 2016-17 figures have been taken as they are the latest available actual figures.
Sources: State Budget Documents; PRS.

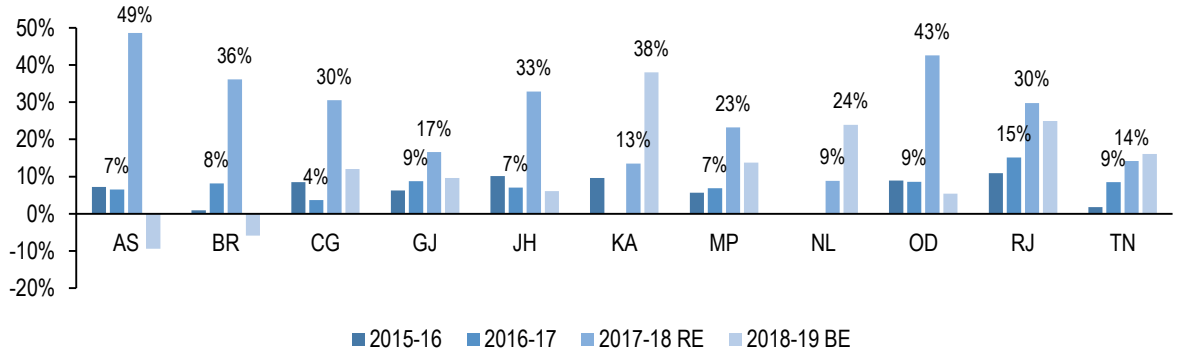
If the 15th Finance Commission, like previous Finance Commissions, recommends that states should eliminate revenue deficit, and if it does not specify revenue deficit grants, states with revenue deficit will be impacted. These include Punjab, Kerala, West Bengal, and Haryana. Elimination of revenue deficit grants would increase the borrowings made by these states. Further, borrowings made will be first spent on revenue expenditure, in turn constraining the capital expenditure of these states.

The burden of expenditure on payment of salaries and pensions is increasing

The 7th Central Pay Commission recommended revisions in salaries and pensions, and other allowances for central government employees.[5] Following this, states such as Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, and Tamil Nadu have implemented Pay Commission awards, with actual payments starting from 2017-18.[6] Others states such as Assam, Odisha, Rajasthan, and Nagaland revise their emoluments from time to time as per their own pay commission rules, and have also effected pay revisions in 2017-18.[6] Gujarat effected its pay revisions from August 2016 and Karnataka from 2018-19.

For states that have started implementing Pay Commission awards from 2017-18, there is a growth of 27.5% in expenditure on salaries and pensions between 2016-17 and revised estimates of 2017-18, as against the average growth of 22% for all 24 states in the same time period (data for Delhi, Tripura, and West Bengal was not available). However, these year-on-year increases may include arrears, and thus could be overstated (Figure 7).

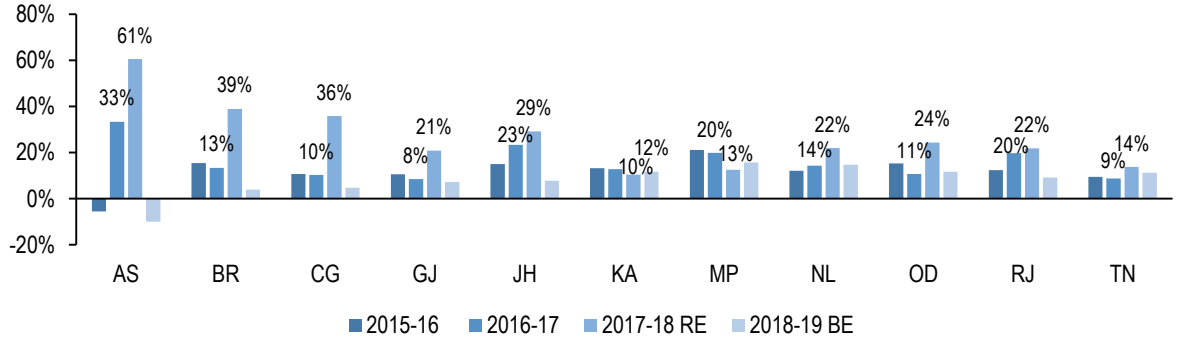
Figure 7: Growth in salaries and pensions of select states that have implemented pay commission awards



Note: The increase in the year of implementation of pay revisions may be overstated as the payments may include arrears. Consequently, growth rate in the following year could be understated (and may even be negative, as in the case of Assam and Bihar).
Karnataka effected its pay revisions from 2018-19, and the graph indicates the data labels accordingly. All other states (except Gujarat) effected their pay revisions from 2017-18. Data for Nagaland was not available for 2015-16 and 2016-17. RE denotes Revised Estimates. BE denotes Budget Estimate.
Sources: RBI State of State Finances, State Budget Documents; PRS.

Expenditure on salaries and pensions forms a part of revenue expenditure. The implementation of Pay Commission awards by certain states has led to a steep increase in their allocations for revenue expenditure between 2016-17 and revised estimates of 2017-18. Revenue expenditure of the 10 states (excluding Karnataka) that have implemented pay commission awards grew by 15% between 2015-16 and 2016-17. However, between 2016-17 and revised estimates of 2017-18 , revenue expenditure grew by 25% (Figure 8).

Figure 8: Growth in revenue expenditure of states that have implemented pay commission awards



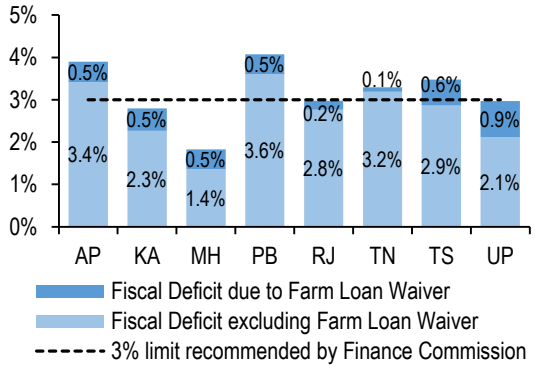
Sources: State Budget Documents; PRS.

The 13th Finance Commission had recommended that salary expenditure of states should not exceed 35% of the revenue expenditure of the state.[4] This threshold has already been breached by Assam and Nagaland. Since salaries and pensions are committed liabilities, an increase in expenditure on them will have a recurring effect on the fiscal balance of states in the future.

Expenditure by states on farm loan waivers and sugarcane arrears have impacted their finances

Farm loan waivers given by states require them to take over farmers' debt. Typically, banks and cooperatives waive off the pending loans of beneficiary farmers on receiving guarantees from the state. Then, provisions for the waiver scheme are made in budgets in a phased manner over the next few years to reimburse the waiver amount and clear the outstanding debts. Table 1 shows details of the farm loan waivers given by states and the allocations made so far. Note that Telangana has completed the implementation of its farm loan waiver scheme, which took four years.

Figure 9: Four states have average fiscal deficit within 3% of GSDP after farm loan waivers



Note: Data for (i) AP for 5 years, (ii) TS for 4 years, (iii) TN for 3 years, (iv) KA, MH, PB, and UP for 2 years, and (v) RJ for 1 year. Figures averaged over the years to show impact in a year.
Sources: State Budget Documents; CSO, MOSPI; PRS.

Table 1: Details of farm loan waivers announced by states since 2014-15 (amount in Rs crore, figures in parentheses indicate amount as a percentage of GSDP)

State	Year	Amount of Loan Waiver	Allocation/ Expenditure	Pending Amount
Andhra Pradesh	2014-15	24,000 (4.6)	16,956	7,044
Telangana	2014-15	17,000 (3.4)	15,167	-
Tamil Nadu	2016-17	6,041 (0.5)	4,548	1,493
Uttar Pradesh	2017-18	36,000 (2.7)	24,558	11,442
Maharashtra	2017-18	34,000 (1.3)	25,060	8,940
Punjab	2017-18	10,000 (2.1)	4,620	5,380
Karnataka	2017-18	42,200 (3.0)	14,508	27,692
Rajasthan	2018-19	8,000 (0.9)	2,000	6,000

Note: Data for Karnataka combines the farm loan waivers announced by the subsequent governments in 2017-18 and 2018-19 budgets.
Sources: State Budget Documents; Central Statistics Office, MOSPI; RBI State of State Finances; PRS.

Telangana's average fiscal deficit is estimated to be 3.5% of its GSDP, of which 0.6% of GSDP is due to farm loan waiver (Figure 9). Andhra Pradesh, which has allocated a similar amount so far over five years (from 2014-15 to 2018-19), has its estimated fiscal deficit at 3.9% of its GSDP, of which 0.5% of GSDP is due to farm loan waiver. These states, as well as Punjab, already have relatively higher borrowing requirements vis-à-vis states such as Karnataka and Maharashtra, whose lower deficit levels give them enough fiscal space to implement farm loan waivers (without crossing the limit of 3% of GSDP).

Since fiscal deficit indicates the borrowing requirement in a fiscal year, the effect of farm loan waivers on liabilities of a state will depend on the number of years of implementation. States which choose to finance the scheme in a single year will see a large impact on fiscal deficit that year, in contrast to a staggered implementation. However, in staggered implementation, states will incur additional costs in the form of interest payments. Thus, farm loan waivers have had varying impacts, depending on the amount of debt waived, the manner of implementation, and that particular state's fiscal condition. The Union Agriculture Ministry has observed that loan waivers might impact the credit culture by incentivising defaulters, and by discouraging farmers who can repay or have made regular repayments.[7] It noted that each waiver given makes it more difficult to reject future demands.

Another recent development in the agriculture sector with bearing on states' finances is that of sugarcane arrears. Sugarcane production increased by 23% in 2017-18, and consequently, the sugar production increased by 46%, as compared to 2016-17.[8,9] With excess production, sugar prices reduced sharply, affecting the liquidity of sugar mills. Since mills are obligated to buy sugarcane from farmers at prices fixed by the government, their inability to pay farmers led to accumulation of dues. Till May 2018, the arrears amounted to Rs 23,232 crore, which is being addressed with government assistance (through soft loans and subsidies).[10] States such as Uttar Pradesh, Punjab, Haryana, Bihar, Tamil Nadu, and Uttarakhand announce State Advised Price (SAP) for the sale of sugarcane, which is much higher than the price approved by the central government.[11] The Commission for Agricultural Costs and Prices noted that SAPs create distortions in the industry, as they do not take into account the domestic and global prices, and other relevant parameters.[11] Such price policies impact the states' finances. For instance, Uttar Pradesh increased its 2018-19 allocation for the sugar industry from Rs 948 crore (0.2% of total allocation) to Rs 6,483 crore (1.4% of total allocation) in its first Supplementary Demands for Grants for 2018-19.

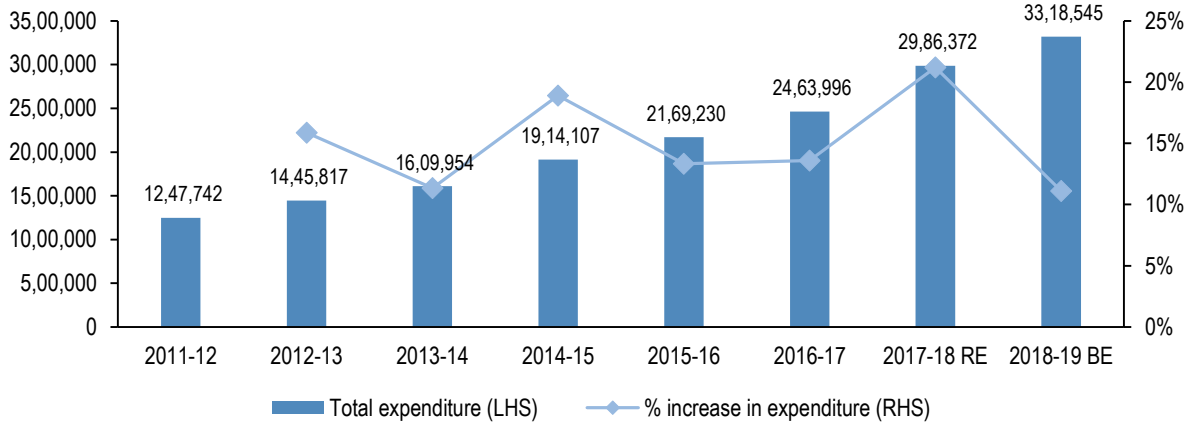
EMERGING TRENDS IN FINANCES OF STATES

This section looks at the finances of the states and trends that have emerged in the last eight years (2011-2019) with respect to their expenditure, receipts, and deficit.

15% average annual growth in total expenditure of all states between 2011 and 2019

States spend their money to provide citizens with a number of services. These comprise expenditure on social services, such as education, health, and social security, and economic services, such as agriculture, irrigation, energy, and transport. States also incur expenditure on general administrative services. In the last eight years, the total expenditure of states has witnessed an average annual growth rate of 15%. It has increased from Rs 12,47,742 crore in 2011-12 to Rs 33,18,545 crore in 2018-19 (Figure 10).

Figure 10: Total expenditure of states has increased at an average rate of 15% (2011-2019) (Rs crore)



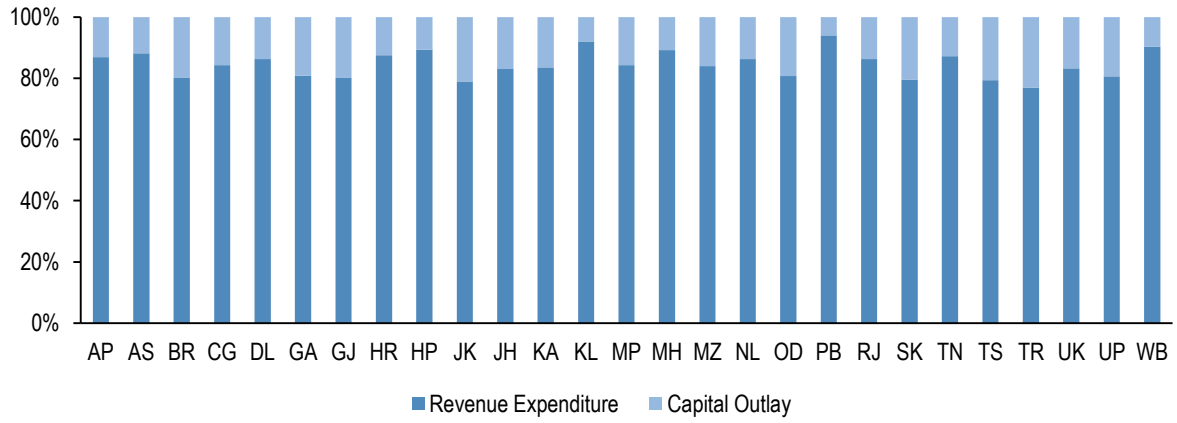
Note: RE denotes revised estimates and BE denotes budget estimates.
Sources: State Budget Documents; PRS.

Revenue expenditure has formed the bulk of total expenditure of all states in the last eight years

The expenditure of states can be classified into two components: (i) revenue expenditure, and (ii) capital expenditure. Revenue expenditure is recurring in nature and includes expenditure on administrative expenses, and on payment of salaries and pensions. Interest payments on loans taken by states also form a part of the revenue expenditure. Capital expenditure includes expenditure on capital outlay for various social and economic services. Such capital outlay leads to the creation of infrastructure such as schools, water supply and sanitation networks, and hospitals.

On average, over the last eight years (2011-2019), states spent 85% of their expenditure on the revenue component, and 15% on capital outlay (Figure 11).

Figure 11: Revenue expenditure is 85% of total expenditure by all states (2011-2019)

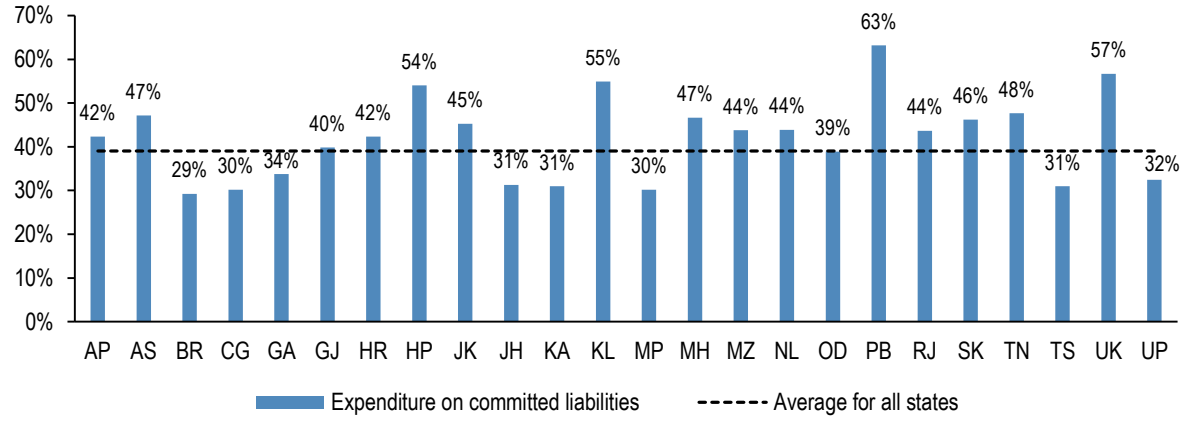


Sources: State Budget Documents; PRS.

44% of revenue expenditure (39% of total expenditure) is spent on committed liabilities

Committed liabilities of a state typically includes expenditure on payment of salaries, pensions, and interest payments. A larger proportion of state budget allocated for committed expenditure crowds out other developmental expenditure. Between 2016-2019, 24 states on an average have spent 39% of their budget on committed expenditure (salaries, pensions, and interest payments) (Figure 12). Punjab spends the most on committed liabilities, followed by Uttarakhand, Kerala, and Himachal Pradesh.

Figure 12: Expenditure on committed liabilities (2016-2019)



Note: Information on payment of salaries and pensions for Delhi, Tripura, and West Bengal is not available.
Sources: State Budget Documents; RBI State of State Finances, PRS.

States spend 61% of their budget on human and economic development, creation of infrastructure and security and administration

Expenditure by states is classified into three broad categories: (i) general services, which includes expenditure on administrative services, police, and payment of interest and pensions, (ii) social services, which includes expenditure on education, health, water supply and sanitation, housing, urban development, and welfare of backward communities, and (iii) economic services, which includes expenditure on agriculture and allied activities, rural development, irrigation, energy, and transportation infrastructure. The first category is called non-developmental expenditure, and the latter two categories are termed as developmental expenditure.

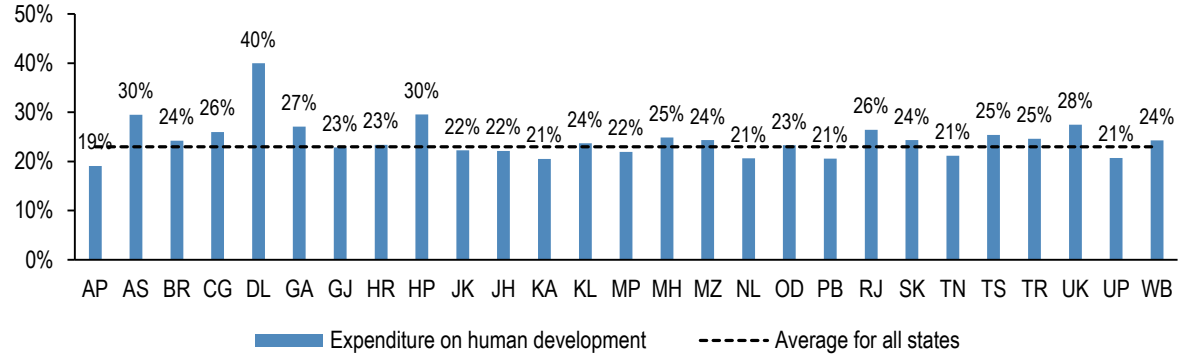
Between 2011-2019, states spent 68% of their budget on developmental expenditure, and 30% of their budget on non-developmental expenditure. The remaining 2% was apportioned as grants-in-aid and contributions, including those given to local bodies and panchayati raj institutions.

An analysis of spending by all states on 11 key sectors between 2011-2019 indicates that on an average, states spend 61% of their budget on human and economic development, infrastructure creation, administration and security of their citizens. Of the remaining 39%, states spend 10% each on payment of interest and pensions, respectively.

23% of states' budget is spent on human development

Expenditure on human development comprises allocations made towards education, health, and water supply and sanitation. Expenditure on these sectors aims to improve the overall well-being of citizens and aids in the creation of human capital. Between 2011 to 2019, states on an average have spent 23% of their budget on human development (Figure 13). Within this, the highest allocation is towards education (17%), followed by health (4%), and the remaining 2% is for water supply and sanitation.

Figure 13: Delhi spends the highest on human development (2011-2019)

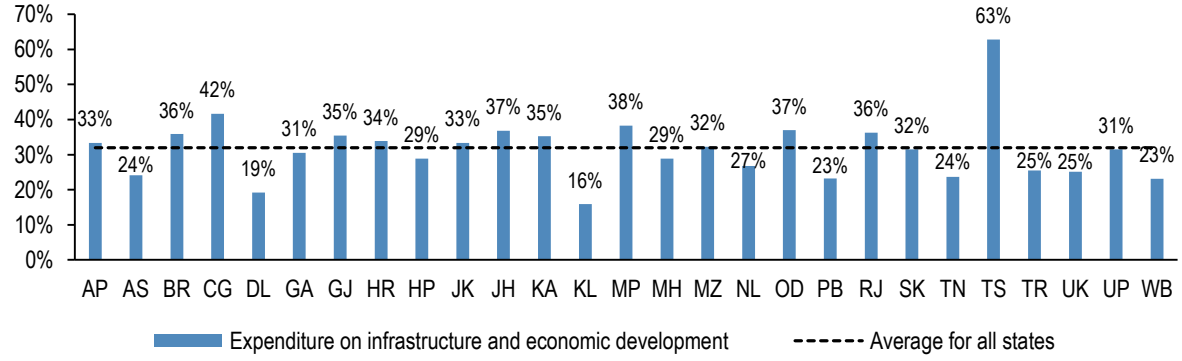


Sources: State Budget Documents; PRS.

States spend 32% of their budget on economic development and infrastructure

Expenditure on economic development and infrastructure creation comprises allocations made towards agriculture, irrigation, urban and rural development, housing, energy, and construction of roads and bridges. Expenditure on these sectors leads to creation of infrastructure in the state, the benefits of which accrue to the state over a long term. Between 2011 to 2019, states on an average have spent 32% of their budget on infrastructure and economic development (Figure 14). Within this, the sectors of agriculture, energy, and rural development are allocated 6% each, followed by an allocation of 5% each to irrigation, and roads and bridges. Urban development and housing are allocated the remaining 4%.

Figure 14: Telangana spends the highest on economic development and infrastructure (2011-2019)

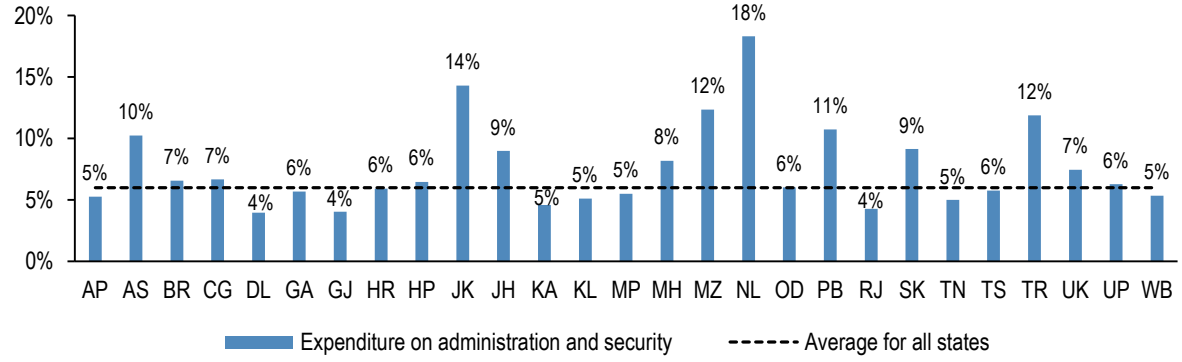


Sources: State Budget Documents; PRS.

Expenditure on administration and security of citizens makes up 6% of states' budget

Between 2011-2019, states spent 5% of their budget on police forces and 1% on administrative services, such as district administration and public works (Figure 15).

Figure 15: Nagaland spends the highest on administration and security

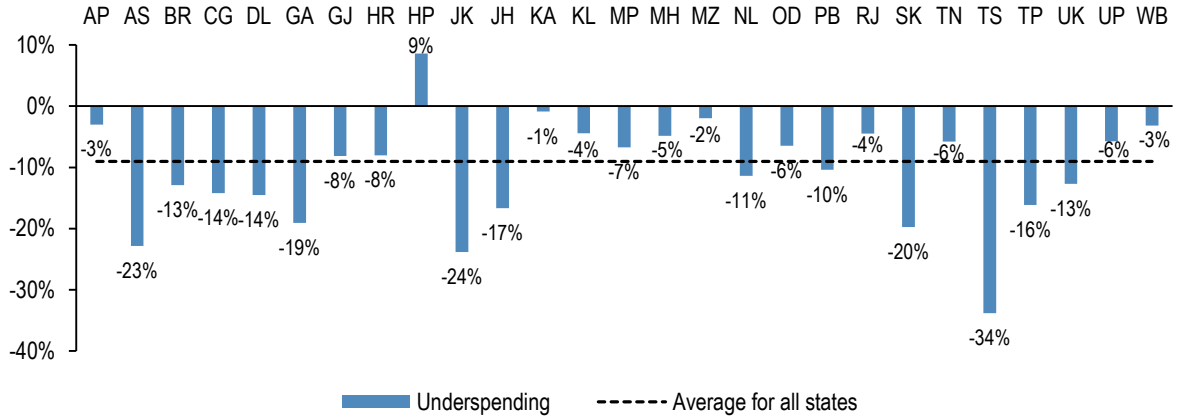


Sources: State Budget Documents; PRS.

States are spending lower than what they are budgeting; Himachal Pradesh overspends

While presenting their budgets before the beginning of the financial year, states estimate the total expenditure that will be incurred in that year. Comparing budget estimates with the actual expenditure for six years (2011-17) shows that on average, states underspend their budget by 9%. Average underspending on revenue expenditure is 7%. However, the underspending on capital expenditure is much higher at 15%. Telangana, Jammu and Kashmir, and Assam underspend the most (Figure 16). On the other hand, Himachal Pradesh overspent its budget estimates by 9% on average.

Figure 16: States on an average underspend their budget by 9% (2011-2017)

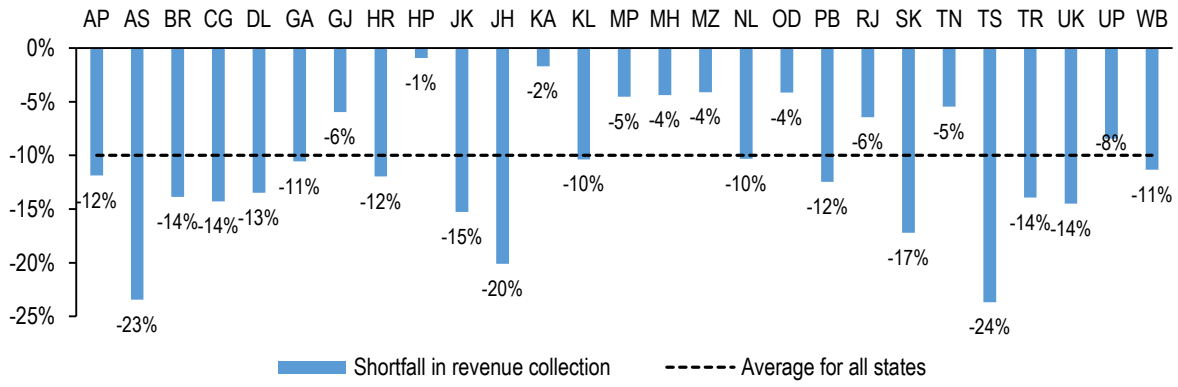


Note: Data for Telangana from 2014-15 onwards.
Sources: State Budget Documents; PRS.

Average underspending by states has increased from 4% in 2011-12 to 11% in 2016-17. This implies that the gap between the predicted budget estimates and the actual expenditure figures has been rising, and budgeted targets have not been met. While the average underspending of capital expenditure has remained range-bound (15%), the under-spending on the revenue component has increased from 2% in 2011-12 to 10% in 2016-17.

This underspending can be attributed to shortfall in revenue collection of states. Between 2011-12 and 2016-17, states made optimistic revenue projections and witnessed an average shortfall of 10% in their revenue collection (Figure 17). Such a scenario would have required states to undertake cuts in their spending and compensate for this shortfall in their receipts.

Figure 17: States on an average witnessed a shortfall of 10% in their revenue collection (2011-2017)



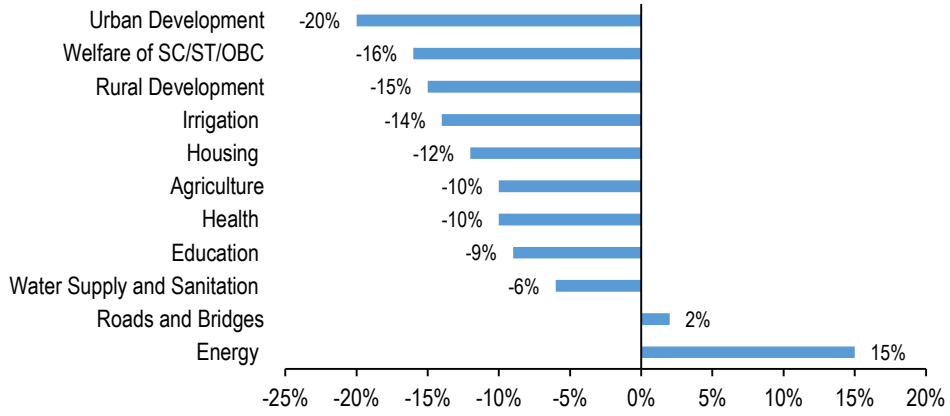
Note: Data for Telangana from 2014-15 onwards.
Sources: State Budget Documents; PRS.

Most sectors also witness underspending; higher than budgeted expenditure on energy

Among major sectors on which state governments spend, urban development witnessed the highest underspending (20%) between 2011-2017 (Figure 18). This was followed by an underspending of 16% on welfare of SC/ST/OBC and 15% on rural development. On the other hand, states under

budgeted their expenditure requirements on energy by 15%, and on construction of roads and bridges by 2%. Energy sector particularly witnessed higher actual expenditure than budgeted due to the implementation of UDAY between 2015-2017 by 14 states (see Figure 32 for more details on the effect of UDAY on state finances). Huge underspending could imply that states are being unable to meet their development targets in specific sectors.

Figure 18: Urban development witnessed the highest underspending; overspending on energy (2011-2017)



Sources: State Budget Documents; PRS.

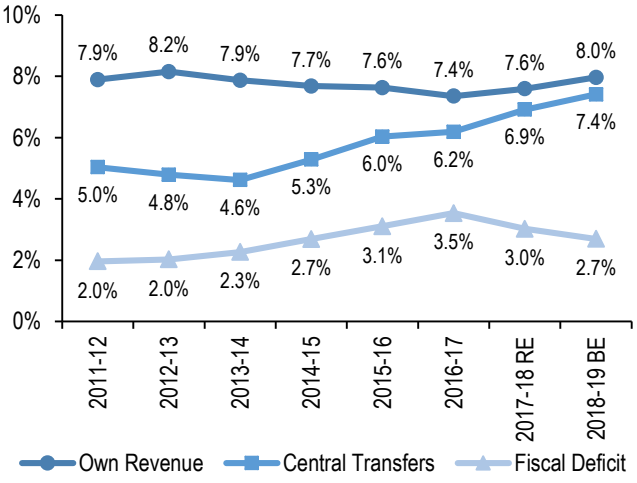
Where do states get the revenue to finance their expenditure?

Receipts of a state can be broadly classified into revenue receipts and capital receipts. Revenue receipts indicate the total revenue of the state. States primarily depend on two revenue sources to meet their expenditure requirements – their own revenue and central transfers. The former indicates revenue generated by states on their own, while the latter consists of receipts from the central government as share of taxes and grants. In addition to these, states also rely on borrowings to finance their expenditure, which is a part of the capital receipts.

States' own revenue remains the largest source of funds in order to meet their rising expenditure (Figure 19). It is estimated to be equivalent to 8% of the combined GSDP of all states in 2018-19. However, central transfers have increased over the years, from 5% in 2011-12 to 7.4% in 2018-19.

The increase of central transfers to 5.3% in 2014-15 can be attributed to the inclusion of those grants-in-aid in state budgets, which were earlier directly allocated to the implementing agencies, bypassing the state budgets. In the subsequent year, the recommendation of the 14th Finance Commission to increase the share of states in union taxes from 32% to 42% was implemented. This increased the central transfers to 6% of GSDP in 2015-16.

Figure 19: Central transfers to states (as a percentage of GSDP) has increased over the years



Note: Data taken for Delhi till 2017-18, and for Tripura till 2015-16.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

On the other hand, state's own revenue as a percentage of GSDP has not witnessed much change since 2011-12. It is estimated to increase to 7.6% of GSDP in 2017-18 and 8% of GSDP in 2018-19. With increases estimated in own revenue and central transfers in both years, fiscal deficit is estimated to decline to 3% of GSDP in 2017-18, and further to 2.7% of GSDP in 2018-19. This comes after a

consistent increase in fiscal deficit, from 2% in 2011-12 to 3.5% in 2016-17. However, note that figures for 2017-18 and 2018-19 are estimated figures, and the actual figures could vary.

Nonetheless, the reliance of states on external sources, i.e., central transfers and borrowings (fiscal deficit), to finance their expenditure has been increasing over the years. The contribution of funds from these two sources increased from 7% of GSDP in 2011-12 to 10.1% of GSDP in 2018-19. While this was less than states' own revenue in 2011-12 (7.9% of GSDP), states now depend more on these sources as compared to their own revenue (8.0% of GSDP in 2018-19). Moreover, out of these two sources, while central transfers are essentially funds that are granted to the states, financing expenditure with borrowings comes with interest payment and repayment obligations.

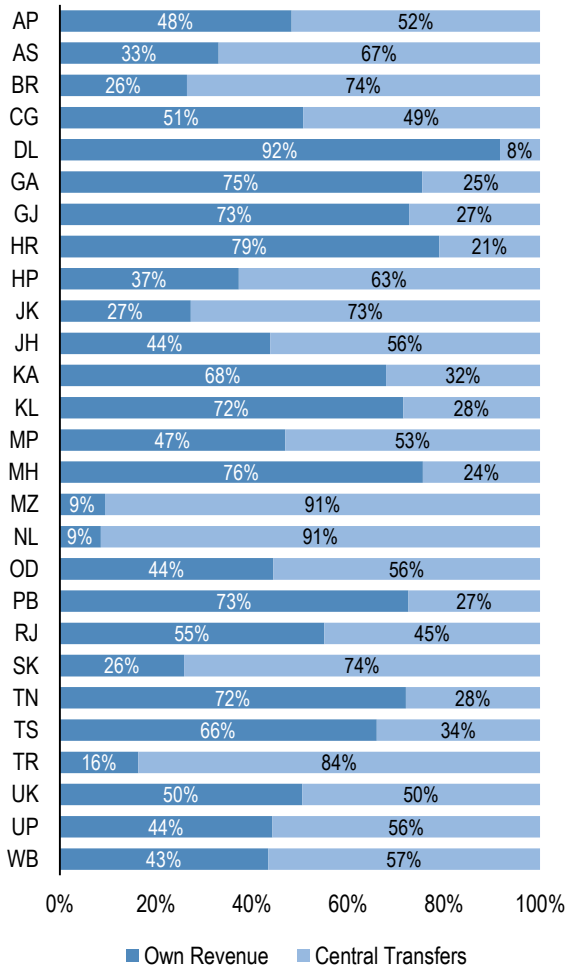
Own tax revenue is the largest source of revenue for most states; own non-tax is the smallest

States' revenue receipts can be categorized into four components: (i) own tax revenue, (ii) own non-tax revenue, (iii) devolution of union taxes, and (iv) grants-in-aid from centre. The former two components add up to give state's own revenue, and the latter two can be classified as central transfers.

During the period 2011-12 to 2018-19, on average, 56% of revenue receipts of states have come from their own revenue, and 44% from central transfers. However, there are variations across states (Figure 20). The contribution of own revenue is significantly higher (more than 70% of total state receipts) in states such as Gujarat, Goa, Haryana, Kerala, Maharashtra, Punjab, and Tamil Nadu. On the other hand, states such as Bihar, Jammu and Kashmir, and the north-eastern states depend on central transfers for most of their revenue.

In states' own revenue, variations are mostly because of differences in tax revenue rather than non-tax revenue (Figure 21). This is because own tax revenue is the larger component, contributing 48% of the total revenue, whereas own non-tax revenue contributes 8%. Share of own non-tax revenue is in the range of 7-14% of total revenue for most states, with some exceptions such as Goa where it contributes 28% to the revenue. It is particularly higher in Goa as the state electricity distribution in the state is through a government department unlike in other states.

Figure 20: Composition of revenue receipts of states (2011-19)



Note: Data for Andhra Pradesh and Telangana from 2014-15 onwards. Share of own revenue in Delhi is significantly higher as compared to others as it does not have any share in the divisible pool of union taxes.
Sources: State Budget Documents; RBI State of State Finances; PRS.

The contribution of devolution of union taxes and central grants in states' revenue is at 26% and 18%, respectively. However, states such as Himachal Pradesh, Jammu and Kashmir, and the north-eastern states are comparatively more dependent on these grants (Figure 22). Unlike devolution, which is constitutionally provided as per the Finance Commission's criteria, most of the grants are allocated by the centre. Grants are tied to specific expenditure priorities and thus, offer states little flexibility and choice. Higher dependence on central grants limits the ability of the states to spend as per their local economic and social priorities.

Figure 21: Composition of states' own revenue (2011-19)

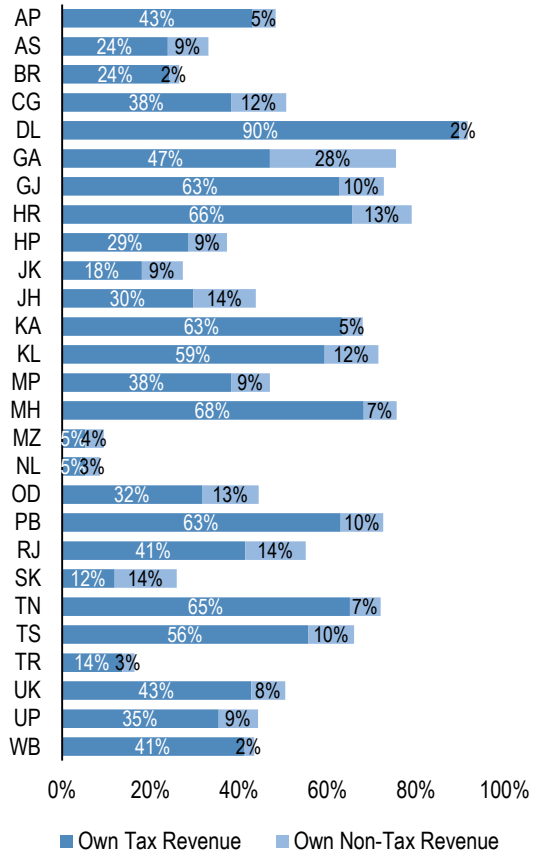
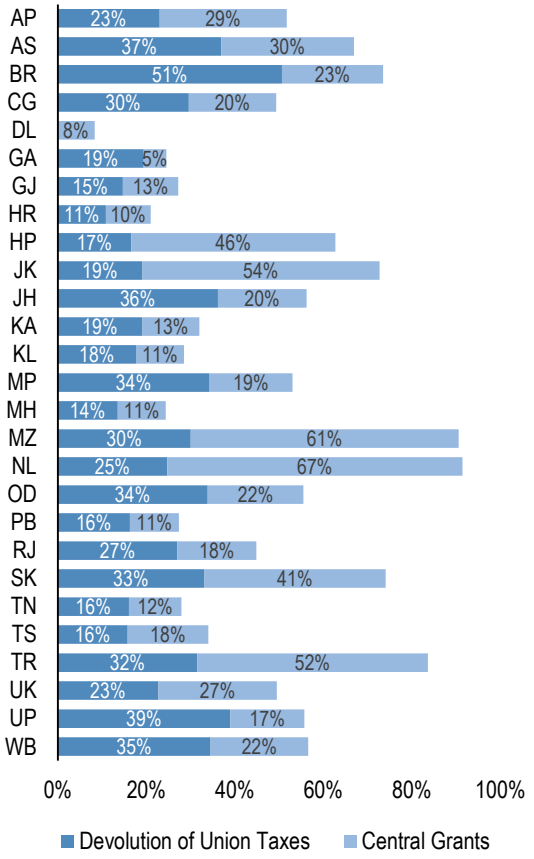


Figure 22: Composition of central transfers to states (2011-19)



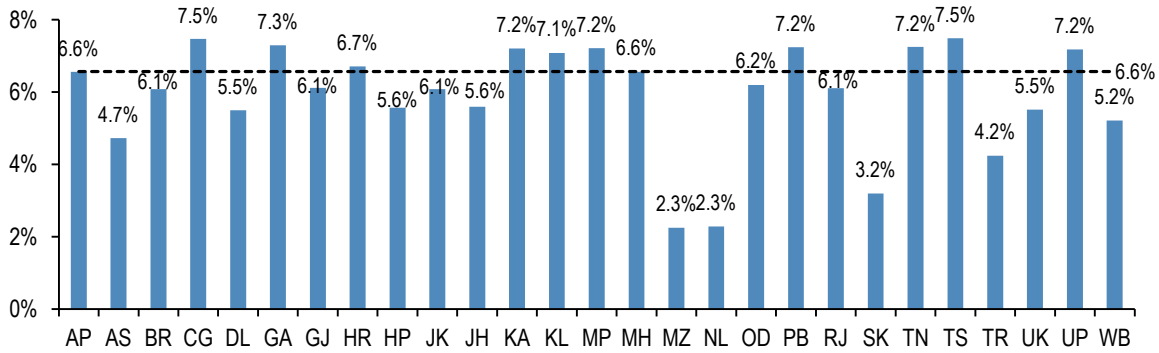
Note: Data for Andhra Pradesh and Telangana from 2014-15 onwards; Sources: State Budget Documents; RBI State of State Finances; PRS.

Own tax revenue grows faster than GSDP for 15 states; comparable own tax-GSDP ratio

As discussed earlier, own tax revenue has been the largest source of revenue (48% of total revenue) for states between 2011-19. Thus, a state's ability to generate tax revenue on its own impacts its overall revenue significantly. Typically, own tax revenue consists of receipts from: (i) goods and services tax (GST), (ii) sales tax/value added tax (VAT), (iii) state excise, (iv) stamps and registration fees, (v) taxes and duties on electricity, and (vi) land revenue, among other taxes and duties.

Own tax-GSDP ratio is a measure of a state's potential to generate taxes from its economy on its own. A higher ratio indicates a better ability to harvest taxes from the economic activities in the state. The average own tax-GSDP ratio of states during 2011-12 to 2018-19 has been 6.6% (Figure 23). The ratio is much lower than the average for the north-eastern states.

Figure 23: North-eastern states have own tax-GSDP ratio much lower than the average of 6.6% (2011-19)

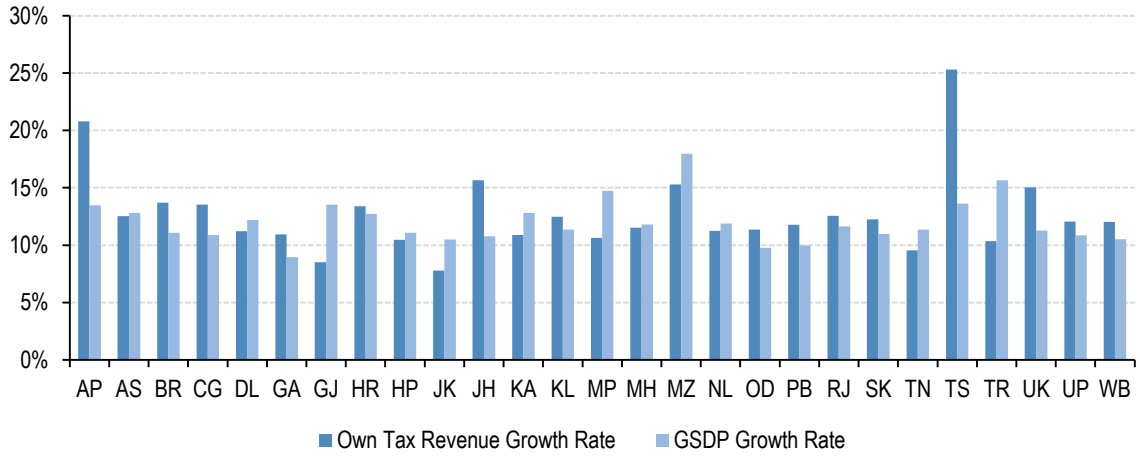


Note: Data taken for Andhra Pradesh and Telangana from 2014-15 onwards, for Delhi till 2017-18, and for Tripura till 2015-16.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

On average, own tax revenue of states has grown at a rate of 12% during 2011-19. While Andhra Pradesh and Telangana have comparatively much higher growth rates at 21% and 25% respectively, Jammu and Kashmir, Gujarat, and Tamil Nadu have witnessed comparatively lower growth rates.

During 2011-19, the growth rate of own tax revenue has been greater than the GSDP growth rate for 15 out of the 27 states (Figure 24). The growth rate of own tax revenue vis-à-vis the GSDP growth rate shows how the ability of a state to generate tax revenue on its own changes as its economy grows. States which have a higher growth rate of own tax revenue than that of GSDP would be able to increase their own tax-GSDP ratio, i.e., their tax generation potential, over the years. In contrast, the ratio would decrease for states whose own tax revenue is growing at a lesser rate than their GSDP.

Figure 24: Growth rate of own tax revenue is more than that of the GSDP for 15 states (2011-19)



Note: Data for Andhra Pradesh and Telangana from 2014-15. GSDP data not available for Delhi for 2018-19 and Tripura from 2016-17.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

Among the states with higher growth rates, own tax revenue of Andhra Pradesh, Jharkhand, Telangana, and Uttarakhand have grown at 1.5-2 times of their GSDP growth rate. This could improve their own tax-GSDP ratio in the future. Note that while Andhra Pradesh and Telangana already have near or above-average own tax-GSDP ratio, the ratio could increase and move towards the average for Jharkhand and Uttarakhand from the present 5.6% and 5.5%, respectively.

On the other hand, the growth rate of own tax revenue is lower at 50-75% of the GSDP growth rate for Madhya Pradesh and Tripura. This could result in a decline in their own tax-GSDP ratio. Madhya Pradesh has an above-average ratio own tax-GSDP ratio of 7.2%, whereas that for Tripura has been much lower at 4.2%.

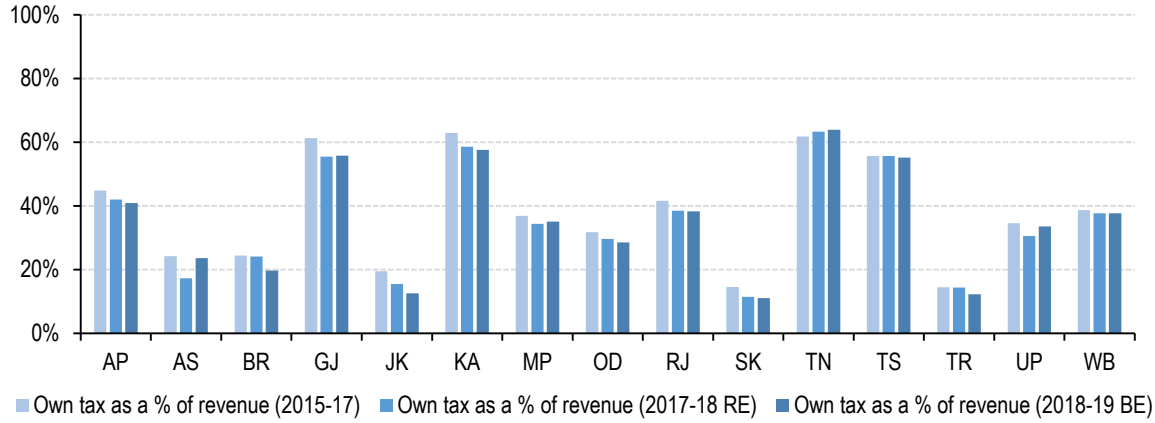
Share of own tax receipts in revenue could change for some states with implementation of GST

Many goods and services which were earlier taxed either by the states or the centre are now subjected to GST by both. Also, earlier, states used to get tax revenue from sale of goods and services in their jurisdiction. At present, the revenue generated by levying GST is split equally between the centre and the destination state, to where the goods and services are supplied by the sellers.

As a result of the changes in taxation structure, the share of own tax receipts in revenue is estimated to change for some states. For Figure 25, only those states have been considered for analysis for which GST components, such as compensation, are clearly discernible in state budgets. In these states, on average, the proportion of own tax receipts in revenue is estimated to decline from 43% (2015-17) to 40% (2018-19 BE). While the proportion is estimated to increase for Tamil Nadu, own tax revenue proportion is estimated to gradually decline for all other states. There could be a drop of nearly five percentage points for states such as Bihar[‡], Gujarat, Jammu and Kashmir, and Karnataka.

[‡] Decrease in case of Bihar is also due to a loss in state excise revenue after enactment of the Bihar Prohibition and Excise Act, 2016.

Figure 25: Share of own tax receipts in revenue likely to change for some states with GST implementation



Note: Own tax revenue of states which have included GST compensation grants as part of their tax revenue has been adjusted accordingly by removing compensation grants. These states include Andhra Pradesh, Gujarat, Jammu and Kashmir, Sikkim, Telangana, and Uttar Pradesh. Data for Andhra Pradesh and Telangana from 2014-15 onwards.
Sources: State Budget Documents; PRS.

Box 1: Compensation expected by states for loss of revenue due to the implementation of GST

Table 2: GST compensation grants expected by states in 2018-19

State	Compensation (in Rs crore)	Compensation as percentage of revenue
Andhra Pradesh	2,000	1.3 %
Assam	1,000	1.4 %
Bihar	3,698	2.3 %
Gujarat	10,296	7.3 %
Jammu and Kashmir	3,175	4.9 %
Karnataka	10,800	6.5 %
Madhya Pradesh	2,600	1.7 %
Odisha	4,074	4.1 %
Rajasthan	4,500	3.0 %
Sikkim	111	1.8 %
Tamil Nadu	1,698	1.0 %
Telangana	1,500	1.2 %
Tripura	147	1.0 %
Uttar Pradesh	5,942	1.7 %
West Bengal	9,876	6.7 %

Note: Due to non-uniform reporting of compensation grants in budgets, there may be other states as well that might require such grants.
Sources: State Budget Documents; PRS.

The Goods and Services Tax (Compensation to States) Act, 2017 provides for compensation to the states for any loss of revenue arising due to the implementation of GST. Compensation grants in case of 15 out of 27 states could be clearly ascertained from their 2018-19 budget documents.

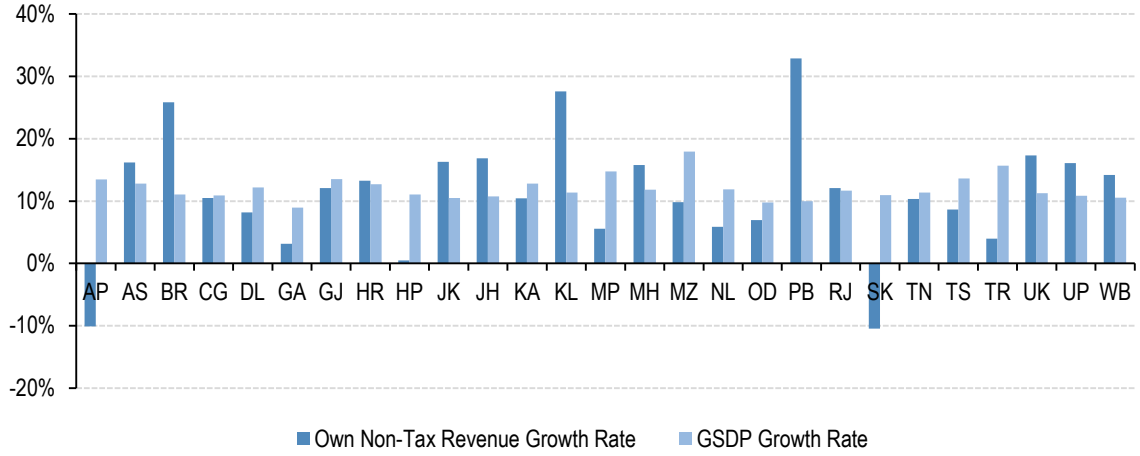
As per the Act, states are liable to receive compensation only for five years from the date their state's GST Act came into force. It implies that the states receiving compensation have only this much time to bridge this gap with other avenues to avoid any potential loss of revenue. This gap is quite significant for states like Gujarat, Karnataka, and West Bengal (6-7.5% of their revenue receipts). When petroleum products are brought under GST, the gap could widen (see Figure 4 on page 3 for more details).

Non-tax revenue of states grows faster than GSDP for 13 states; growth varies across states

Own non-tax revenue has been the source for 8% of states' revenue, on average, during 2011-19. States earn non-tax revenue through various sources, including interest earned on loans provided by states, dividend from public sector enterprises, licensing fee for mineral exploration, and fee levied in relation to forestry, among others.

While the average growth rate in own non-tax revenue of states has been 12%, the growth is primarily because of higher growth rate in a few states, such as Punjab, Kerala, and Bihar at 33%, 28%, and 26%, respectively (Figure 26). Including these, 13 states have growth rates higher than their GSDP growth rates. In Andhra Pradesh and Sikkim, own non-tax revenue decreased at a rate of 10%, due to lower interest receipts and lottery receipts, respectively.

Figure 26: States' own non-tax revenue grows at 12%, with variation across states (2011-19)



Note: The negative growth rates for Andhra Pradesh and Sikkim are because of the sharp decrease in their non-tax revenue in 2015-16. In Andhra Pradesh the non-tax revenue decreased due to a decrease in interest receipts. The decrease in non-tax revenue in Sikkim was due to decrease in revenue from state lotteries.
Data for Andhra Pradesh and Telangana from 2014-15. GSDP data not available for Delhi for 2018-19 and for Tripura from 2016-17.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

Box 2: Avenues utilised by states for generation of non-tax revenue

Certain states depend more on non-tax sources to generate their revenue. In 2018-19, Goa, Haryana, Punjab, Kerala, Rajasthan, Jharkhand, Chhattisgarh, Assam, and Orissa expect to generate more than 10% of their revenue through non-tax sources.

Primarily, states utilise three major sources for non-tax revenue generation:

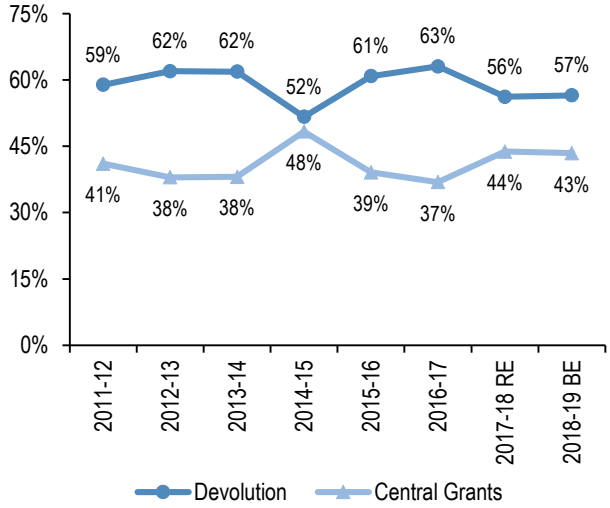
(i) Interest Receipts;
(ii) General Services: consists of revenue generated from police and administration (including fines and fees), and state lotteries; and
(iii) Industries: consists of royalties from mining industries, and revenue generated from other industries.

In Goa, the dependence is high as 66% of non-tax revenue is expected to come from sale of electricity through its power distribution scheme and 12% from mining industries. Haryana expects to generate 53% of its non-tax revenue from urban development and road transport. Kerala and Punjab are estimated to get 84% and 71% of their non-tax revenue from general services, respectively. Jharkhand, Chhattisgarh, and Odisha expect 78%, 73%, and 69% of their non-tax revenue to come from industries, respectively.

Devolution in central transfers increased after 14th Finance Commission's recommendations

Central transfers to states comprise of receipts from devolution of union taxes and grants-in-aid from the centre. The net proceeds of union taxes are devolved to the state governments as per the recommendations of the Finance Commission. These taxes currently include: (i) income tax, (ii) corporation tax, (iii) CGST, (iv) centre's share of IGST, (v) customs, and (vi) union excise duty, among others. The 14th Finance Commission increased the share of states in the union pool of taxes from 32% to 42% for the period 2015-16 to 2019-20. As a result, the share of devolution in central transfers increased from 52% in 2014-15 to 61% in 2015-16 (Figure 27).

Figure 27: Devolution formed 61% of central transfers after the 14th Finance Commission's recommendations



Note: Delhi has not been taken into consideration as it does not have any share in the net proceeds of taxes devolved to states.
Sources: State Budget Documents; RBI State of State Finances; PRS.

While these devolution receipts are untied, i.e., states can decide the way they want to spend it, central grants are tied in nature. They are linked to specific schemes and avenues of expenditure, based on which states distribute these funds among the implementing agencies for these schemes. Such schemes include Sarva Shiksha Abhiyan, and National Health Mission. Grants-in-aid also include grants given by the Finance Commission for local bodies and panchayats.

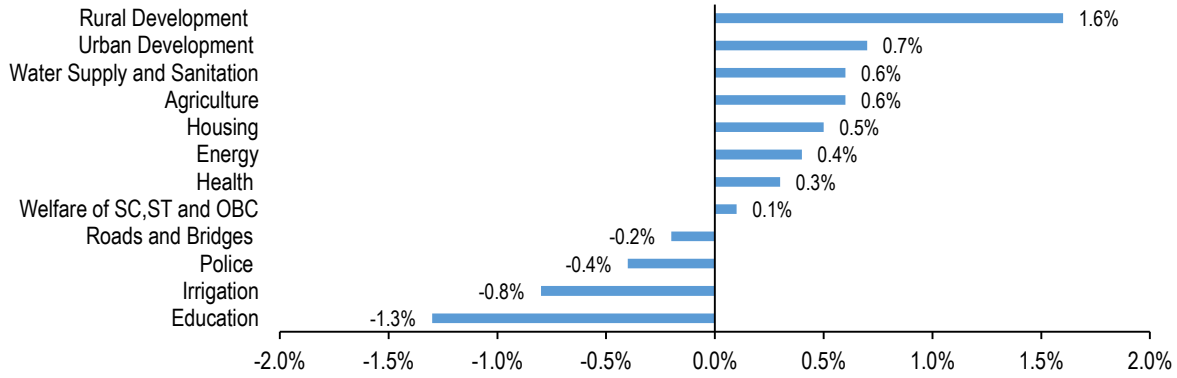
Before 2014-15, some of these funds were directly given to the implementing agencies by the centre, which now goes through the states' budgets. As a result, the proportion of central grants in central transfers increased from 38% in 2013-14 to 48% in 2014-15.

After increased devolution, expenditure on most sectors has remained range-bound

The 14th Finance Commission recommended devolution of a higher share of centre's taxes to the states. As a result, states now have the flexibility to spend according to their priorities, and decide which programs to implement using the additional funds received from the centre.

A comparison of the budgets presented between the years 2015 to 2018 (part of the 14th Finance Commission period) with budgets presented before 2015 (between 2011 to 2014) shows that the average expenditure on rural development has seen the maximum increase (Figure 28). It has increased from 4.4% in 2011-15 to 6% in 2015-19. Average expenditure on education has seen the maximum decrease of 1.3% (from 17.3% to 16%). Expenditure on other key sectors has remained mostly range-bound (i.e., an increase or decrease of less than 1%). Refer to Annexure to see the changes in expenditure priorities of individual states in these sectors post 14th Finance Commission.

Figure 28: Change in share of expenditure on major sectors in Pre and Post Finance Commission period



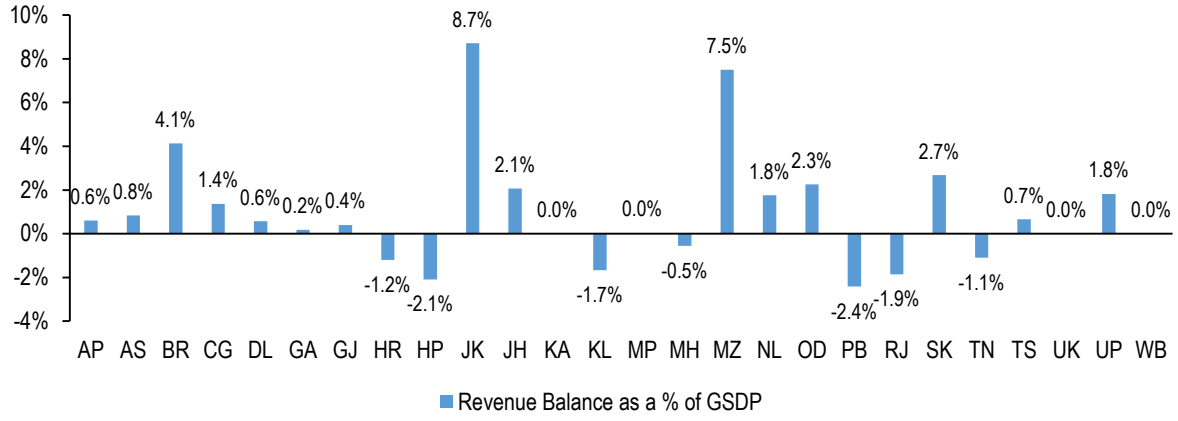
Note: Figures for 2017-18 are revised estimates and 2018-19 are budget estimates.
Sources: State Budget Documents; PRS.

States with recurring revenue deficit have again projected revenue deficit in 2018-19

In 2018-19, seven states have estimated a revenue deficit in their budget (Figure 29). These include Kerala, Punjab, Rajasthan, Himachal Pradesh, Haryana, Maharashtra, and Tamil Nadu. This implies that borrowings made by these states will first be used to supplement their revenue expenditure. Note

that these seven states already have a revenue deficit in 2016-2017 (see Figure 6). Of these, the 14th Finance Commission has given revenue deficit grants to only Himachal Pradesh till 2020 and Kerala till 2017. This implies that the target set by the Commission for Kerala to eliminate it revenue deficit has already been breached by the state.

Figure 29: Seven states expect their revenue to be in deficit in 2018-19



Sources: State Budget Documents; PRS.

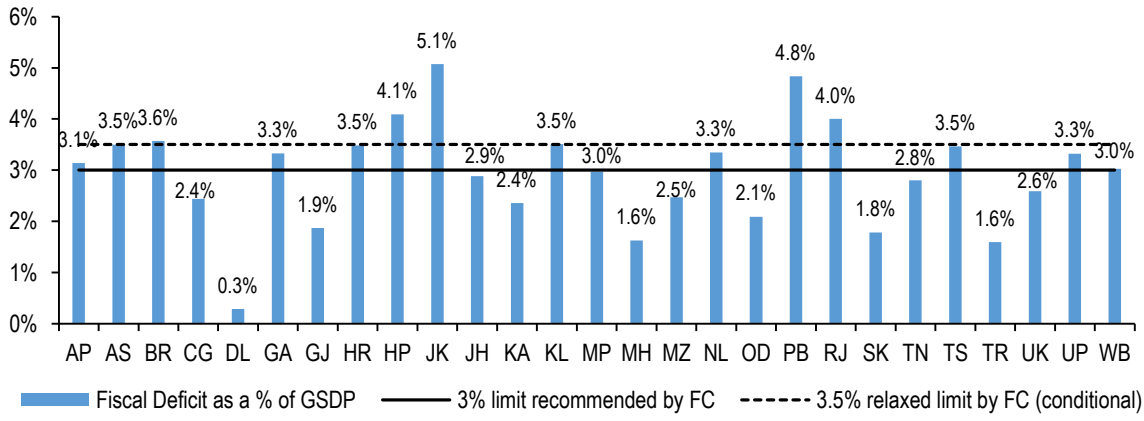
Average fiscal deficit of states at 2.8% of GSDP during 2011-19; 13 states over the 3% limit

Fiscal deficit is the excess of government expenditure over its receipts. A high fiscal deficit of a government implies a higher borrowing requirement in a financial year. The borrowed funds may be spent by the state for various purposes, such as capital investments, administrative expenditure, interest payments, and repayment of loans.

In 2015, the 14th Finance Commission recommended that states maintain their fiscal deficit within 3% of their GSDP. It suggested that the fiscal deficit limit should be relaxed to a maximum of 3.5% if states were able to contain their debt and interest payments to specified levels. The relaxation would be allowed in the following cases: (i) 0.25%, if the debt-GSDP ratio of the state was under 25% in the preceding year, and (ii) 0.25%, if interest payments of the state were less than or equal to 10% of its revenue receipts in the preceding year.

Over the period 2011-12 to 2018-19, 14 states have been able to maintain their average fiscal deficit within the limit recommended by the Finance Commission (Figure 30). Of the 13 states that crossed that limit, eight states have contained their fiscal deficit within the conditional limit of 3.5% prescribed by the Finance Commission. States that have crossed the 3.5% limit include: (i) Bihar at 3.6%, (ii) Himachal Pradesh at 4.1%, (iii) Jammu and Kashmir at 5.1%, (iv) Punjab at 4.8%, and (v) Rajasthan at 4%.

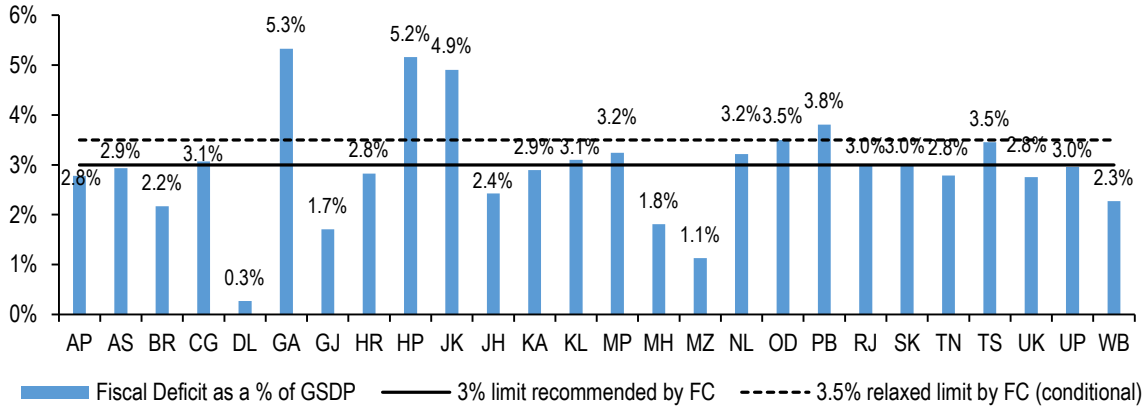
Figure 30: 13 states have average fiscal deficit over the recommended limit of 3% of GSDP (2011-19)



Note: Data for Telangana from 2014-15 onwards. Data not available for some years for Delhi (2018-19) and Tripura (2016-17 onwards).
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

According to 2018-19 budget estimates, 15 states have estimated their fiscal deficit to be within the limit of 3% of their GSDP (Figure 31). Of the remaining, four states expect their fiscal deficit to cross the 3.5% conditional limit. These states are Goa (5.3%), Himachal Pradesh (5.2%), Jammu and Kashmir (4.9%), and Punjab (3.8%). While Himachal Pradesh, Jammu and Kashmir, and Punjab have had high fiscal deficits on an average during the period 2011-19, Goa had a much lower fiscal deficit in previous years (3.3% of GSDP during 2011-19).

Figure 31: 15 states expect to contain their fiscal deficit within the limit of 3% of their GSDP in 2018-19



Note: Data not available for 2018-19 for Delhi and Tripura. Data used for Delhi correspond to 2017-18.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

Of the 15 states that expect to contain their fiscal deficit within 3% of GSDP, nine have their estimates in the range of 2.8% to 3%. This implies that these states are estimated to reach the 3% limit or would be very close to it. At the end of the fiscal year, these states could end up crossing the limit, either due to a shortfall in revenue or due to unforeseen expenditure requirements. To ensure that they maintain their fiscal deficit below this limit, they will have to exercise strict fiscal discipline.

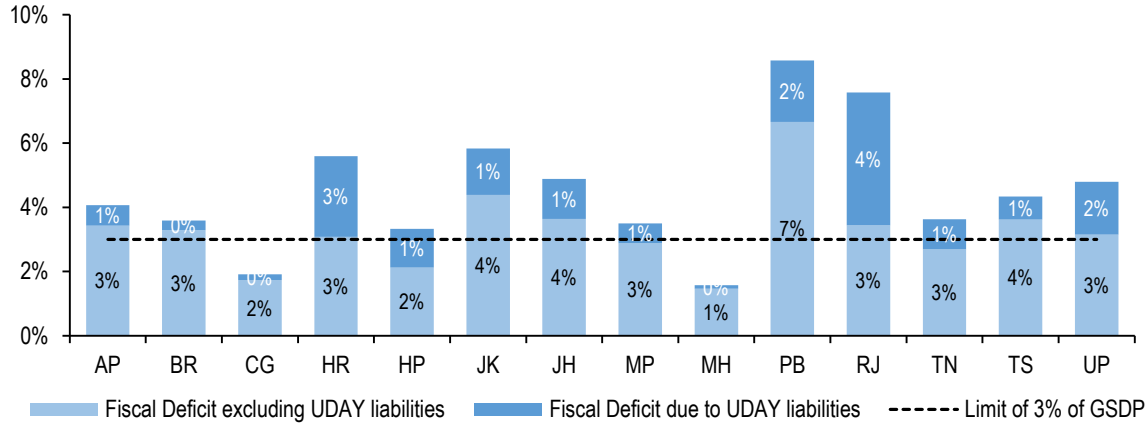
UDAY liabilities increased the fiscal deficit of states by an average of 1.1% of their GSDP

In November 2015, the central government launched the Ujwal Discom Assurance Yojana (UDAY) to improve the financial situation of state-owned power distribution companies (discoms). Before its introduction, the debt of the discoms stood at over Rs 4 lakh crore, as of March 2015.[12] States signing up for the UDAY scheme were required to take over 75% of the discoms' debt over a period of two years – 50% of the debt in the first year of the scheme, and the remaining 25% in the second year. By shifting the debt from state-owned discoms to government accounts, the liabilities of the state governments are more accurately shown. Note that there could be sizable debt in other state enterprises as well, such as road transport corporations and irrigation corporations, which are contingent liabilities for the government and are currently not reflected in state finances.

The scheme provided that the debt taken over from discoms would not be included in the fiscal deficit for 2015-16 and 2016-17 for the purpose of the FRBM Act limits. Nonetheless, the scheme increased the debt burden for these states. For the 14 states that had outstanding liabilities due to UDAY at the end of 2016-17 (Figure 32), the average fiscal deficit during 2015-16 and 2016-17 was at 4% of GSDP, of which 1.1% of GSDP was due to UDAY liabilities. Moreover, in addition to repayment of these liabilities, states have to incur further expenditure under this scheme after 2016-17, such as for providing for the losses of discoms, if any, and interest payments on the outstanding liabilities.

Of these 14 states, Chhattisgarh (1.9%) and Maharashtra (1.6%) had their fiscal deficit (average for the years 2015-16 and 2016-17) within the recommended limit of 3% of GSDP, after accounting for the contribution of UDAY liabilities. Other than these, only Himachal Pradesh had its fiscal deficit within the conditional limit of 3.5% of GSDP. In Haryana and Rajasthan, the contribution of UDAY liabilities to fiscal deficit was comparable to or even higher than the fiscal deficit due to rest of the borrowings. The average fiscal deficit during the two years was highest for Punjab at 8.6% of GSDP, of which 1.9% of GSDP can be attributed to UDAY liabilities.

Figure 32: Two states have fiscal deficit within 3% of GSDP after accounting for their UDAY liabilities



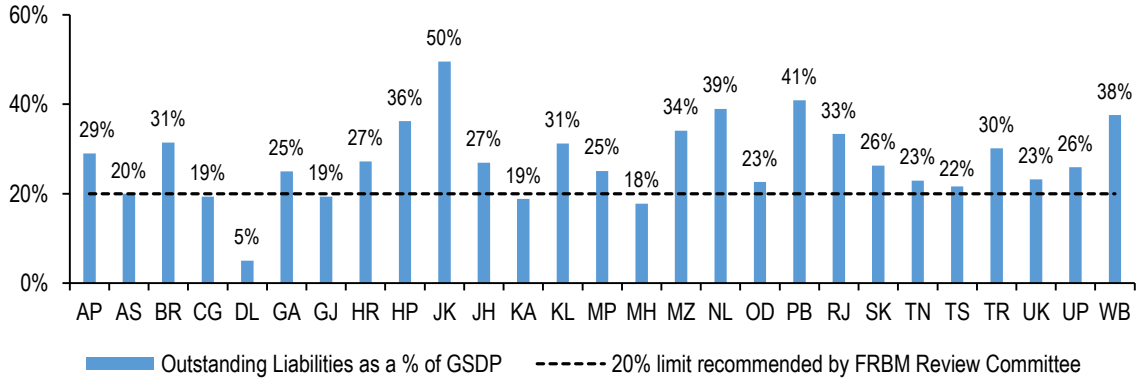
Note: Data shown here are for those states which had outstanding liabilities due to UDAY at the end of March 2017. These liabilities have been averaged over a period of two years to show their impact on a fiscal year.
Source: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

Liabilities of states expected to be at 24.4% of GSDP; most could cross the recommended limit

Outstanding liabilities refer to debt accumulated from financing the fiscal deficit in the past, which the state owes as on date. Higher liabilities indicate a higher obligation for states to repay loans in the future. In 2017, the FRBM Review Committee (Chair: Mr. N. K. Singh) reviewed the status of fiscal governance across the centre and states. It suggested using debt (i.e., total liabilities at the end of the year) as the primary target for fiscal policy, as opposed to the current way of using fiscal deficit (i.e., borrowing requirement for the year). The Committee recommended that a debt to GDP ratio of 60% should be targeted for the entire country, with a 40% limit for the centre and 20% limit for the states.

20 states are estimated to cross the 20% limit recommended by the FRBM Review Committee in 2018-19. Moreover, the FRBM laws of states usually specify limits on the outstanding liabilities as well, which are not always strictly adhered to. The Committee suggested that grounds on which the government can deviate from these targets should be clearly specified, and governments should not be allowed to notify other circumstances, unlike in the current FRBM Acts.

Figure 33: Outstanding liabilities of states estimated to be at 24.4% of GSDP (2018-19 BE)



Note: Data for Delhi and Tripura are for 2017-18 and 2015-16, respectively.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

In 2018-19, Jammu and Kashmir is estimated to have the highest liabilities at 50% of its GSDP, followed by Punjab at 41% (Figure 33). Note that these are also the states with one of the highest fiscal deficit over the period 2011-19 at 5.1% of GSDP and 4.8% of GSDP, respectively (refer to Figure 30). This implies that not only these states have higher debts, but their annual borrowing requirements have been higher as well. Increasing outstanding liabilities could affect the ability of the states to borrow more in subsequent years as per their requirements.

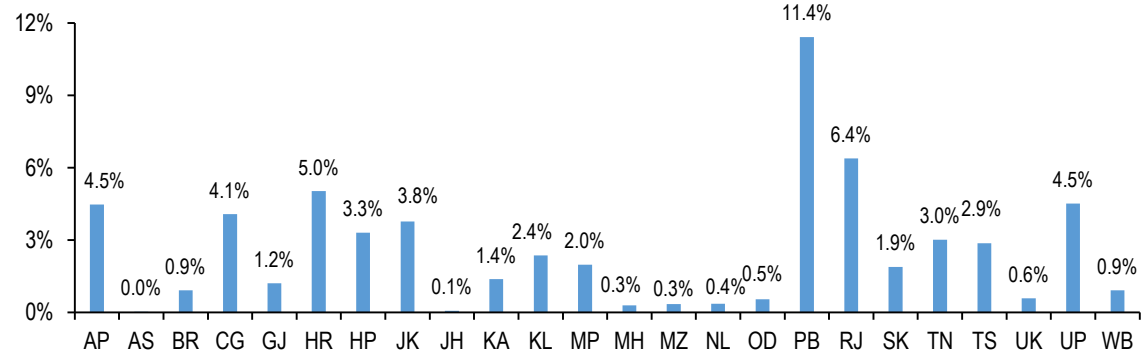
States have provided guarantees worth 2.6% of their GSDP

Outstanding liabilities, as discussed earlier, do not include a few other liabilities that are contingent in nature, which states will have to honour in certain cases. State governments provide guarantees on loans taken by state government-owned public sector enterprises (SPSEs). This may be because these enterprises have a poor credit profile and a government guarantee will make it easier for them to obtain a loan. However, if these SPSEs default on their loan repayments, state governments will be liable to honour their guarantee and make the repayment instead.

For example, as part of the UDAY scheme, states took over the debt of the state-owned power distribution companies. As discussed earlier (Figure 32), these UDAY liabilities contributed an average of 1.1% of GSDP to the fiscal deficit of 4% of GSDP during 2015-16 and 2016-17. RBI has noted that these contingent liabilities are a risk to state governments owing to the large outstanding debt and losses of SPSEs.

As of 2017-18, states have accrued such contingent liabilities worth 2.6% of their GSDP (Figure 34). These guarantees are significantly higher for some states as compared to others. Punjab, Rajasthan, and Haryana have outstanding guarantees worth 11.4%, 6.4%, and 5% of their GSDPs. In comparison, these figures are less than 1% for nine states.

Figure 34: Guarantees given by some states are significantly higher as compared to others (2017-18 RE)



Note: Data not available for Delhi, Goa, and Tripura. Data used for Chhattisgarh, Himachal Pradesh, Kerala, Madhya Pradesh, Maharashtra, Odisha, Rajasthan, and Telangana are for 2016-17. Data used for Jharkhand and Uttar Pradesh are for 2015-16. Data used for Haryana and West Bengal are for 2014-15.
Sources: State Budget Documents; RBI State of State Finances; Central Statistics Office, MOSPI; PRS.

[1] Central Excise and Customs Tariff Table, Petroleum Planning and Analysis Cell, Ministry of Petroleum and Natural Gas, October 12, 2018, http://ppac.org.in/WriteReadData/userfiles/file/PP_2_CustomsExciseTariff.xls.

[2] S.O. 3755(E), Gazette of India, Ministry of Finance, November 27, 2017, http://egazette.nic.in/WriteReadData/2017/180483.pdf.

[3] Report of the Fourteenth Finance Commission, February 2015, http://www.prsindia.org/uploads/media/Report%20Summaries/14th%20Finance%20Commission%20Report.pdf.

[4] Report of the Thirteenth Finance Commission, February 2010, http://www.prsindia.org/uploads/media/13financecommissionfullreport.pdf.

[5] Report of the 7th Pay Commission, November 2015, https://www.finmin.nic.in/sites/default/files/7cpc_report_eng.pdf?download=1.

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[7] Lok Sabha Unstarred Question No. 1104, Ministry of Agriculture and Farmers Welfare, July 24, 2018, http://164.100.47.190/loksabhaquestions/annex/15/AU1104.pdf.

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[11] Price Policy for Sugarcane – 2018-19 sugar season, Commission for Agricultural Costs and Prices, Ministry of Agriculture and Farmers' Welfare, July 2018, https://cacp.dacnet.nic.in/ViewQuestionare.aspx?Input=2&DocId=1&PageId=42&KeyId=623.

[12] UDAY (Ujwal DISCOM Assurance Yojana) for financial turnaround of Power Distribution Companies, Press Information Bureau, Cabinet, November 5, 2015.

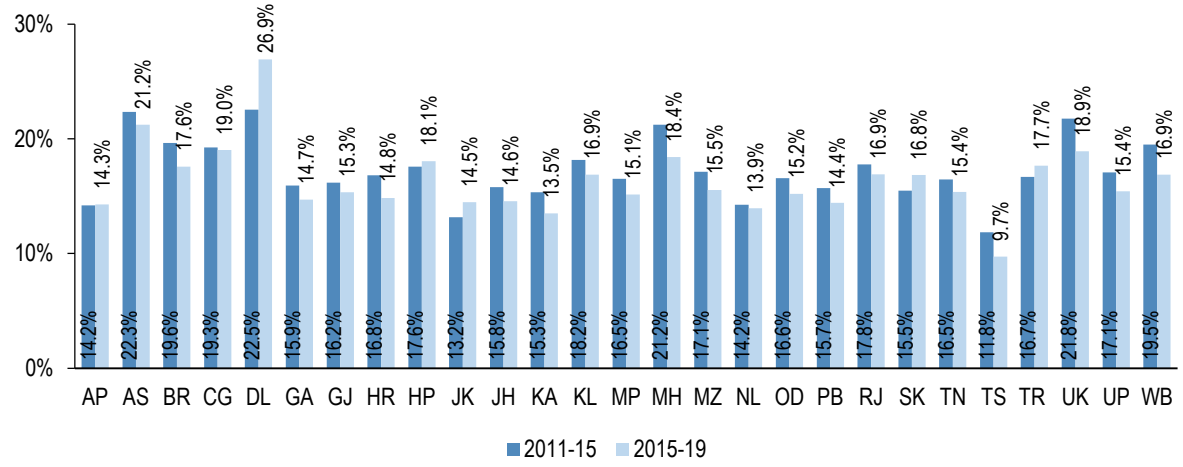
ANNEXURE

This section analyses expenditure by states on key sectors over an eight-year period. To assess the expenditure priorities of states and changes that could have occurred due to increased devolution of untied funds to states, expenditure is compared across two time periods: pre 14th Finance Commission (2011-12 to 2014-15, i.e., four of the total five-year period) and post 14th Finance Commission (2015-16 to 2018-19). This comparison will help us see how states used their increased flexibility to allocate funds. For some items, per-capita expenditure has also been calculated to show how states fare in comparison to each other. Though Delhi, being a Union Territory is not a part of the Finance Commission's devolution process, we have included it in this section to ensure completeness.

Education

Between 2011-15, states on an average spent 17.3% of their budget on education. This includes expenditure on schemes (such as the Sarva Shiksha Abhiyan and the Midday Meal scheme), construction and maintenance of school buildings, and payment of salaries and pensions of teaching and other staff. During 2015-19, this figure deceased by 1.3 percentage points to 16%.

Figure 35: Maharashtra and Uttarakhand have reduced their allocation to education by 2.8% each from 2011-15 to 2015-19

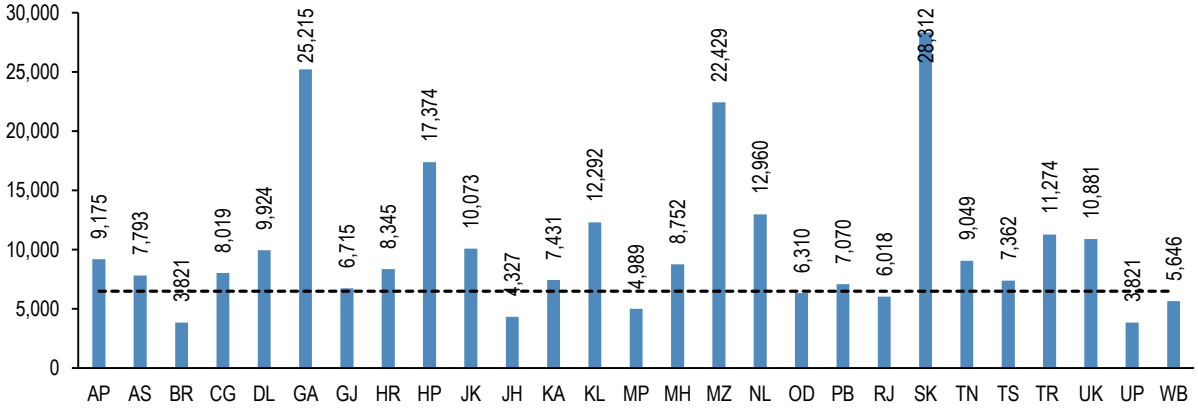


Note: Figures for 2017-18 are revised estimates and 2018-19 are budget estimates.
Sources: State Budget Documents; PRS.

Per-capita expenditure on education

States on an average spend Rs 6,471 per person per year on education (6-23 years of age). Sikkim spend the highest per-capita on education at Rs 28,312. This is almost four times the average for all states. Goa has the second highest (Rs 25,215) per-capita expenditure on education. The states with low per-capita expenditure on education include Bihar, Jharkhand, and Uttar Pradesh.

Figure 36: Bihar and Uttar Pradesh have the lowest per-capita expenditure on education (in rupees)

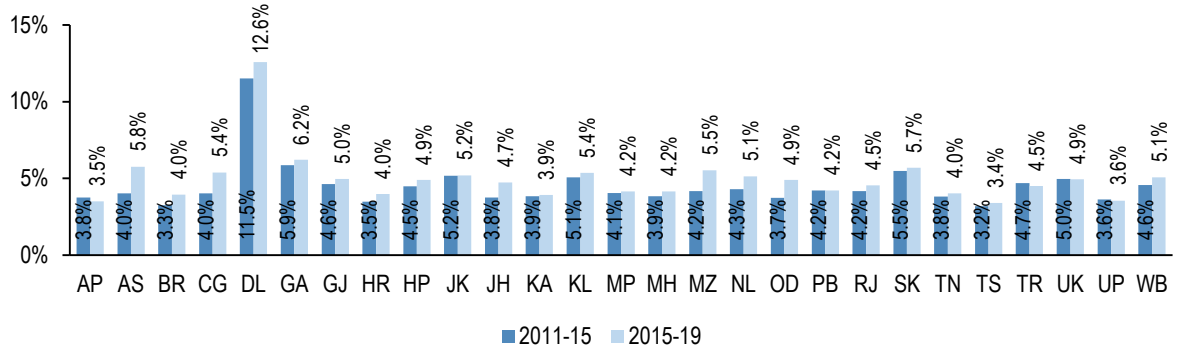


Sources: Ministry of Human Resource Development Projected Population in Different Age Groups- 2016, available at http://mhrd.gov.in/sites/upload_files/mhrd/files/statistics/PopulationProjection2016%20updated.pdf; State Budget Documents; PRS.

Health

Between 2011-15, states on an average spent 4.1% of their budget on health. This includes expenditure on schemes such as the National Health Mission, construction and maintenance of hospitals, and payment of salaries and pensions to hospital staff. During 2015-19, average expenditure on health as increased marginally to 4.4%.

Figure 37: Assam has witnessed the highest increase in expenditure on health from 2011-15 to 2015-19

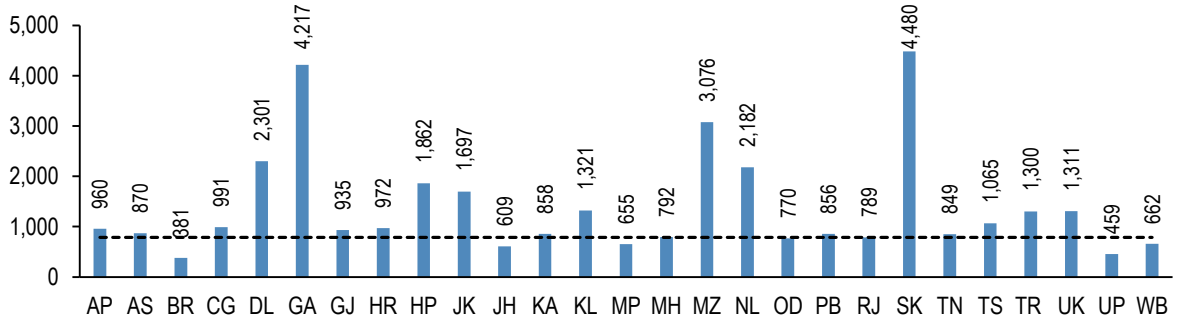


Note: Figures for 2017-18 are revised estimates and 2018-19 are budget estimates.
Sources: State Budget Documents; PRS.

Per-capita expenditure on health

States on an average spend Rs 785 per person per year on health. Sikkim has the highest per-capita expenditure on health, which is almost six times the average for all states. Delhi has the second highest per-capita expenditure on health. The states with the lowest per-capita expenditure are Bihar and Uttar Pradesh.

Figure 38: 21 states spend more than the average per-capita expenditure on health (in rupees)

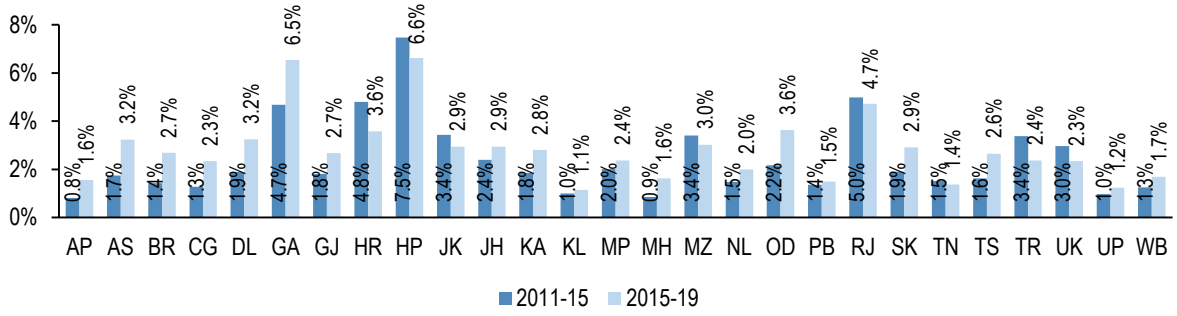


Sources: Census 2011, Report of the 14th Finance Commission, State Budget Documents; PRS.

Water Supply and Sanitation

Between 2011-15, states on an average spent 1.8% of their expenditure on water supply and sanitation. This increased to 2.4% during 2015-19.

Figure 39: Goa has witnessed the highest increase in expenditure on water supply and sanitation from 2011-15 to 2015-19

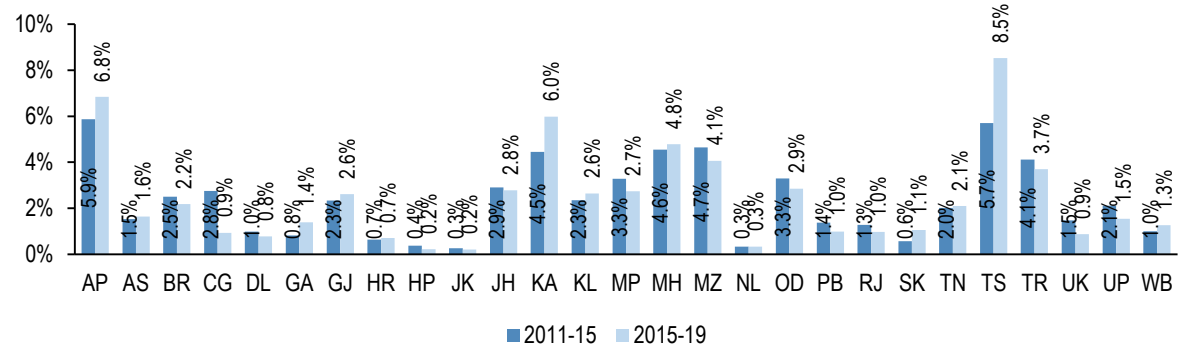


Sources: State Budget Documents; PRS.

Welfare of SC, ST, and OBCs

Between 2011-15, states on an average spent 2.8% of their budget on the welfare of SC, ST and OBCs. This remained range-bound between 2015-19 at 2.9%.

Figure 40: Telangana has witnessed the highest increase in expenditure on welfare of SC, ST and OBC from 2011-15 to 2015-19

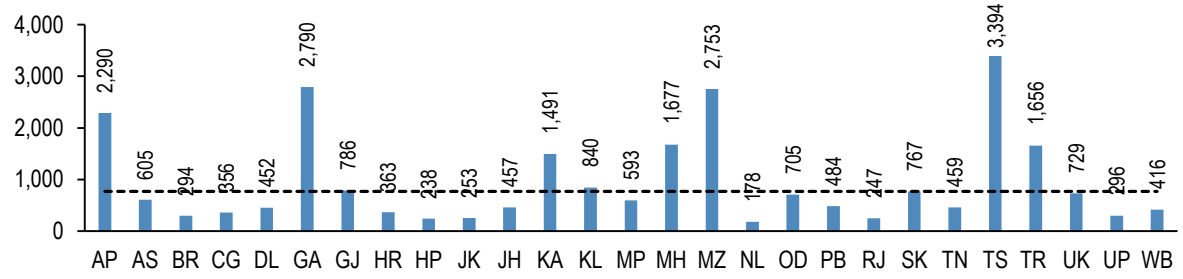


Sources: State Budget Documents; PRS.

Per-capita expenditure on Welfare of SC, ST, and OBCs

States on an average spend Rs 770 per-capita per year on the welfare of their SC, ST, and OBC population. Note that although Goa has the lowest proportion (30%) of population belonging to SC, ST, and OBC in the country, it spends the second highest per-capita on their welfare. Although 87% of the population of Nagaland belongs to SC, ST, and OBCs, it spends the least per-capita among all states on their welfare.

Figure 41: Telangana spends the highest per-capita on welfare of SC, ST, and OBCs (in rupees)

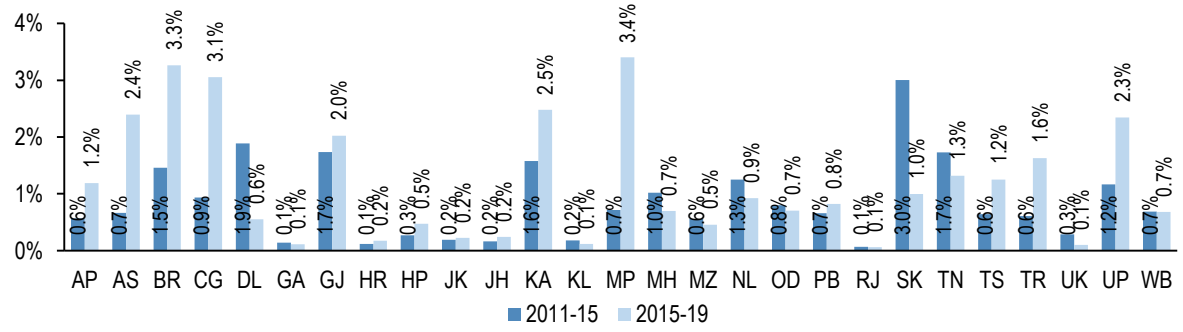


Sources: Handbook on Social Welfare Statistics-2016, Ministry of Social Justice and Empowerment, available at http://socialjustice.nic.in/writereaddata/UploadFile/HANDBOOK%20Social%20Welfare%20Statistice%202016.pdf; Census 2011, Report of the 14th Finance Commission, State Budget Documents; PRS.

Housing

Between 2011-15, states on an average spent 0.9% of their expenditure on housing. During 2015-19, this figure increased by 0.5 percentage points to 1.4%.

Figure 42: Madhya Pradesh has seen the maximum increase in expenditure on housing from 2011-15 to 2015-19

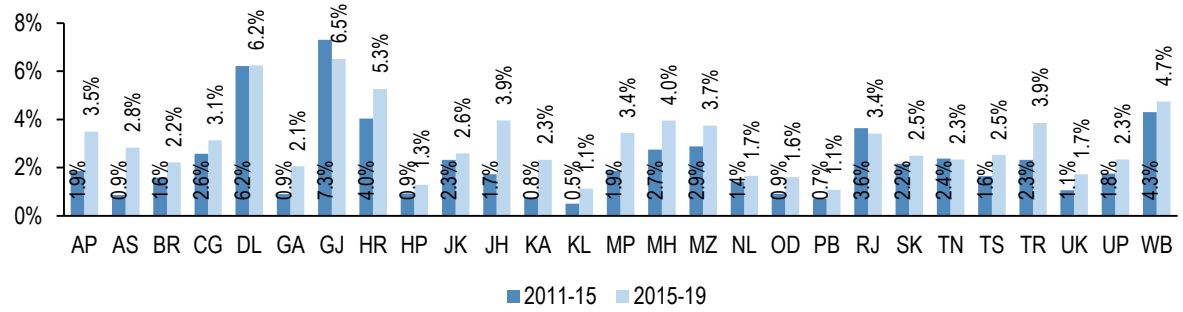


Sources: State Budget Documents; PRS.

Urban Development

Between 2011-15, states on an average spent 2.4% of their budget on urban development. This increased to 3.1% during 2015-19.

Figure 43: Jharkhand has increased its expenditure by 2.2% (maximum among all states) between 2011-15 to 2015-19

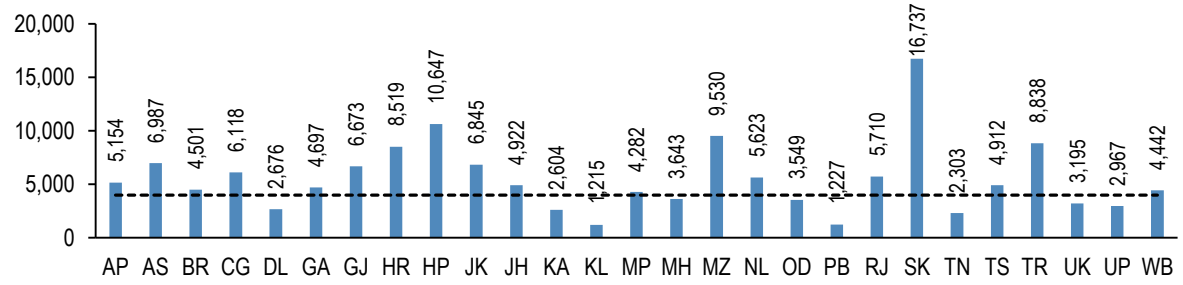


Sources: State Budget Documents; PRS.

Per-capita expenditure on urban development

States on an average spend Rs 3,983 per person per year on the population in urban areas. Sikkim spends the highest per-capita on urban development, followed by Himachal Pradesh. Note that only 10% of the population of Himachal Pradesh is urban. Delhi, which has the largest urban population (97%), spends less than the average on urban development. Among all states, Kerala spends the least per-capita on urban development, although approximately half the population of the state is urban.

Figure 44: Sikkim has the highest per-capita expenditure on urban development (in rupees)

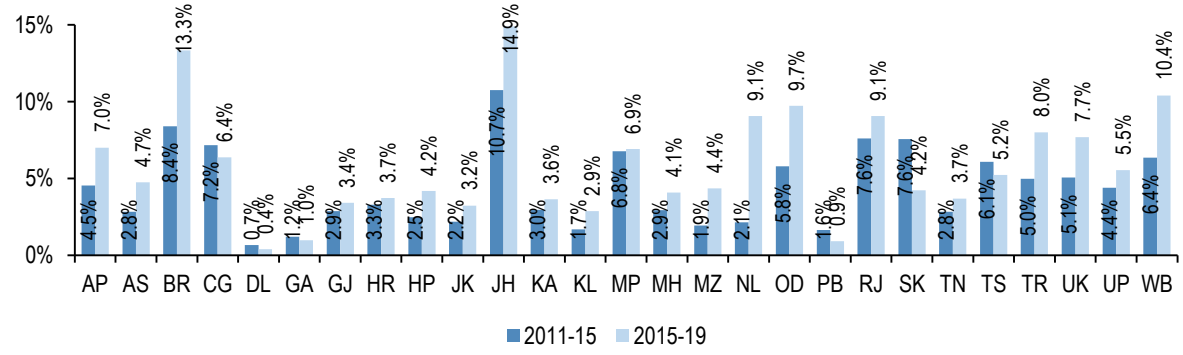


Sources: Census 2011, Report of the 14th Finance Commission, State Budget Documents; PRS.

Rural Development

Between 2011-15, states on an average spent 4.4% of their budget on rural development. This includes implementation of various rural development schemes, such as the National Rural Employment Guarantee Scheme, and the Swachh Bharat Mission. During 2015-19, expenditure on rural development increased to 6%.

Figure 45: Nagaland witnessed the maximum increase of 7% in expenditure on rural development from 2011-15 to 2015-19

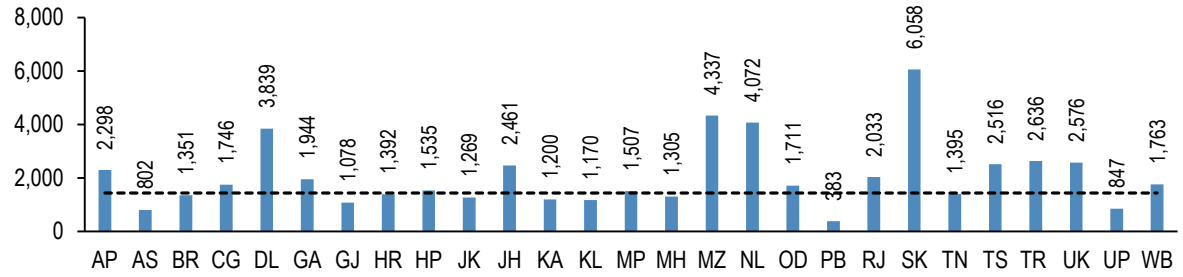


Sources: State Budget Documents; PRS.

Per-capita expenditure on rural development

All states on an average spend Rs 1,434 per person per year on the population in rural areas. Sikkim spends the highest per-capita on rural development. Punjab spends the least per-capita on rural development. Note that 63% of the population of Punjab is rural. Uttar Pradesh, which has the highest rural population in the country (78% of its population is rural) spends Rs 847 per-capita on rural population.

Figure 46: Punjab spends the least per-capita on rural development (in rupees)

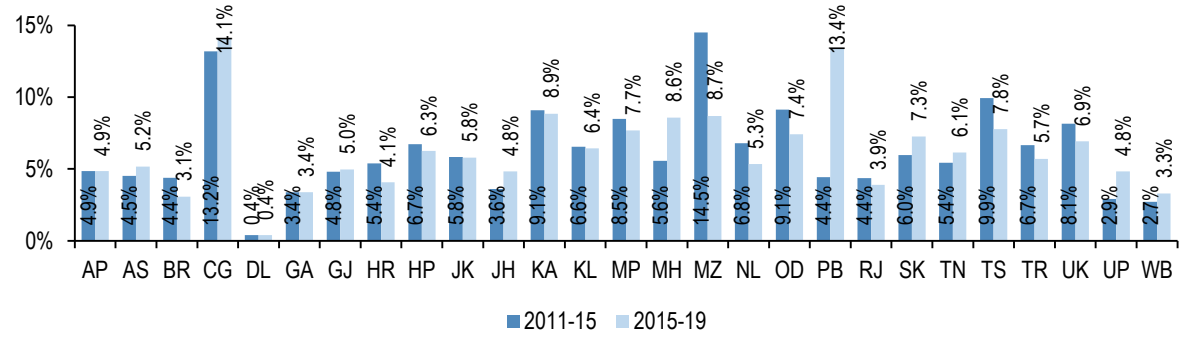


Sources: Census 2011, Report of the 14th Finance Commission, State Budget Documents; PRS.

Agriculture

Expenditure under this head includes expenditure on subsidies, agricultural marketing, crop husbandry, horticulture, waiver of agricultural loans (in some states), and implementing schemes, including Prime Minister Fasal Bima Yojana and Rashtriya Krishi Vikas Yojana. Between 2011-15, states on an average spent 5.6% of their budget on agriculture. This has increased to 6.2% between 2015-19.

Figure 47: Punjab increased its expenditure on agriculture by 9% from 2011-15 to 2015-19

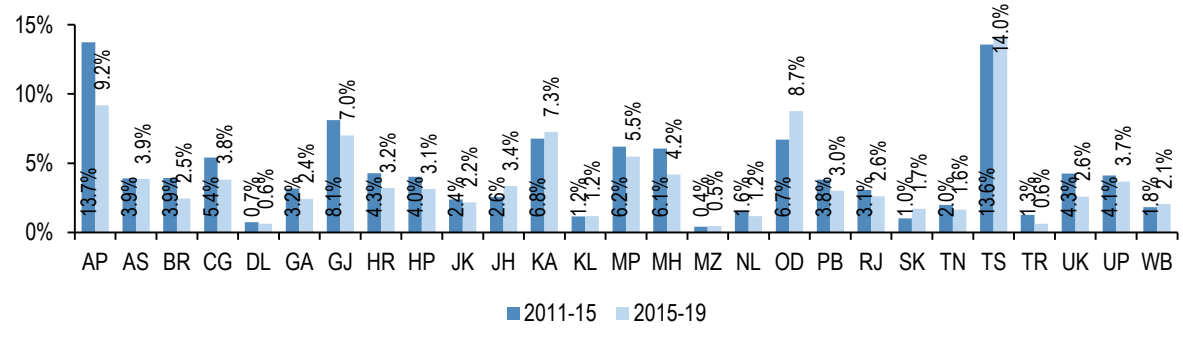


Sources: State Budget Documents; PRS.

Irrigation

Between 2011-15, state on an average spent 5.3% of their budget on irrigation. This has reduced to 4.5% during 2015-19.

Figure 48: Andhra Pradesh witnessed the maximum reduction of 4.5% in expenditure on irrigation from 2011-15 to 2015-19

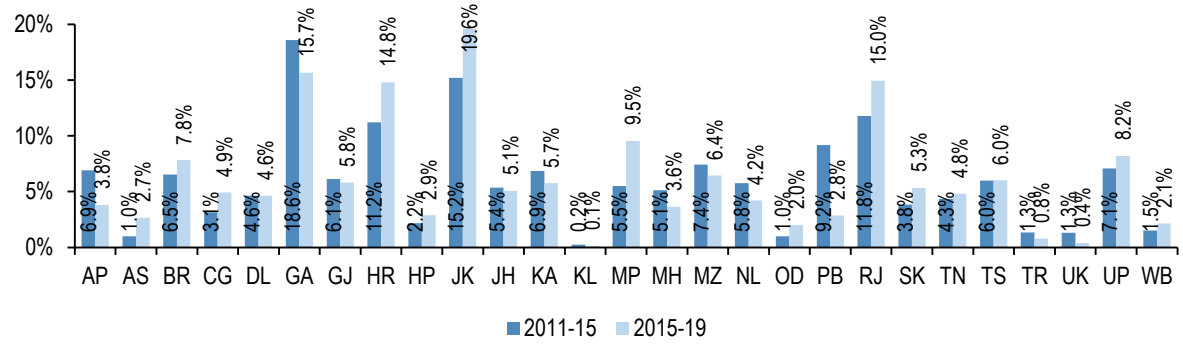


Sources: State Budget Documents; PRS.

Energy

Expenditure under this head includes subsidy to consumers, and allocation for power projects. Some states also have provisions to give assistance to power distribution companies under the UDAY scheme. Between 2011-15, states on an average spent 5.8% of their expenditure on energy. This increased to 6.2% between 2015-19.

Figure 49: Jammu & Kashmir witnessed the maximum increase of 4.4% in expenditure on energy from 2011-15 to 2015-19

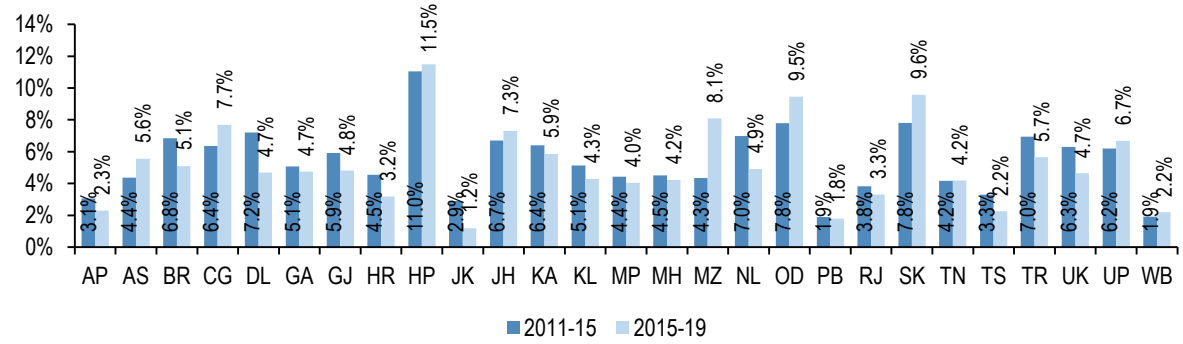


Note: Expenditure by Goa is high as the state electricity distribution is through a government department unlike other states.
Sources: State Budget Documents; PRS.

Roads and Bridges

Between 2011-15, states on an average spent 4.9% of their expenditure on construction of roads and bridges. This has reduced marginally to 4.7% during 2015-19.

Figure 50: Delhi witnessed the maximum reduction of 2.5% in expenditure on roads and bridges from 2011-15 to 2015-19

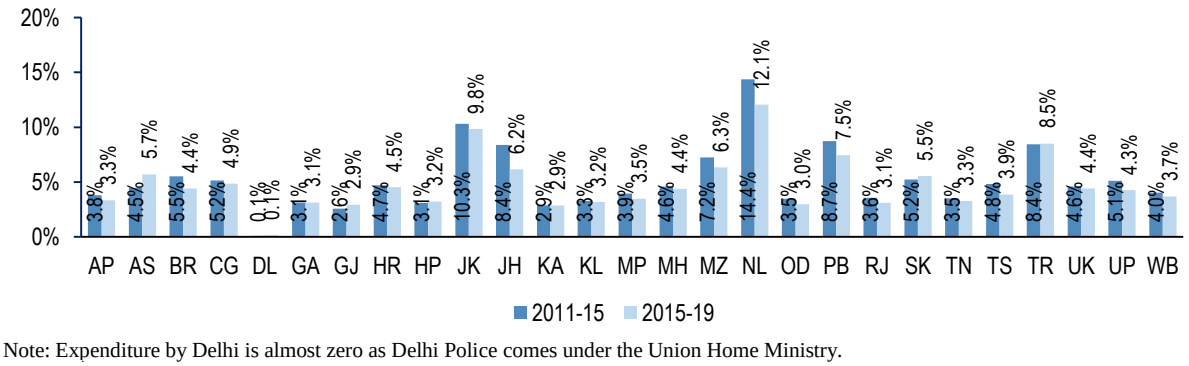


Sources: State Budget Documents; PRS.

Police

Between 2011-15, states on an average spent 4.4% of their expenditure on police. This has reduced to 4% during 2015-19.

Figure 51: Nagaland has reduced its expenditure on police by 2.3% from 2011-15 to 2015-19



Note: Expenditure by Delhi is almost zero as Delhi Police comes under the Union Home Ministry.
Sources: State Budget Documents; PRS.

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