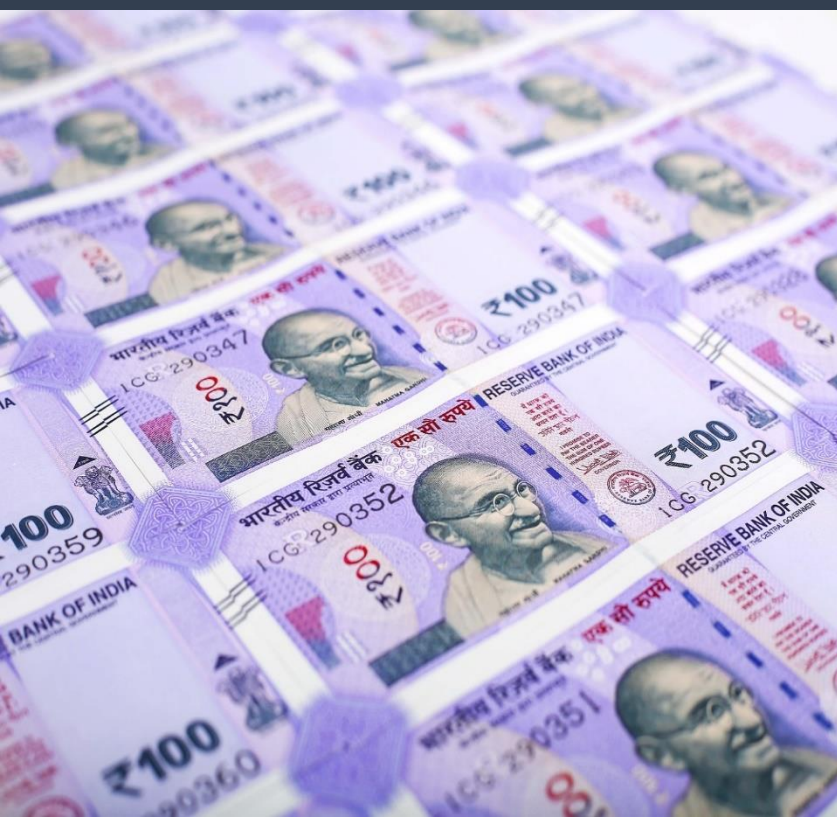


STATE OF STATE FINANCES

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December 2019



GST compensation cess collections may not be sufficient to meet states' requirement

15th Finance Commission's recommendations to impact states' revenue during 2020-26

Revenue shortfall leading to lower spending by states; higher cut in capital outlay

In 2019-20, states are expected to spend 64% more than the central government, a significant change from 46% in 2014-15. Hence, states are assuming greater responsibility in governmental spending in the country. States primarily rely on three sources for financing this expenditure: (i) own resources (44%), (ii) transfers from the central government (35%), and (iii) borrowings (21%). Own resources of states have undergone a major shift since 2017 with the implementation of GST, under which states transferred a major part of their taxation powers to the GST Council. With 2019-20 being the last year of the 14th Finance Commission period, the Terms of Reference of the 15th Finance Commission and its recommendations will direct a major share of states' revenue (35% during 2015-20) during the six-year period 2020-26. With such uncertainties surrounding revenue, states borrow to maintain their expenditure, subject to the limits as per their FRBM laws. These limits on borrowings combined with revenue shortfall and large one-time expenditure programmes (e.g. farm loan waivers and UDAY) are leading to states cutting their planned expenditure. In this context, we look at recent developments that affect state finances and the trends in various components of state finances, i.e., receipts, expenditure, debt, and deficit.

This report is based on the data compiled from budget documents of the states for the last ten years. This report covers 27 of the 28 states (except Manipur), erstwhile state of Jammu and Kashmir, and Delhi. Arunachal Pradesh features partially, as figures for Arunachal Pradesh are based on three-year data (2017-20). Data for expenses on salaries and wages, outstanding liabilities, and guarantees given by state governments has been taken from various sources provided by RBI. The following abbreviations are used for the states in the charts throughout the report.

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

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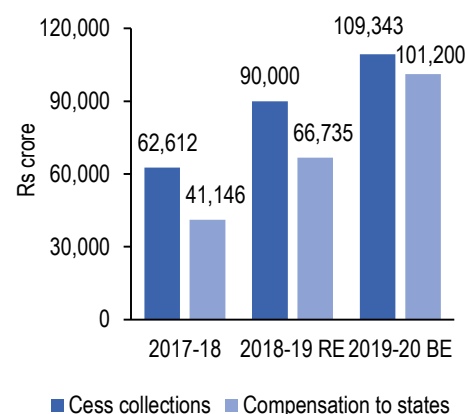
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DEVELOPING THEMES IN STATE FINANCES

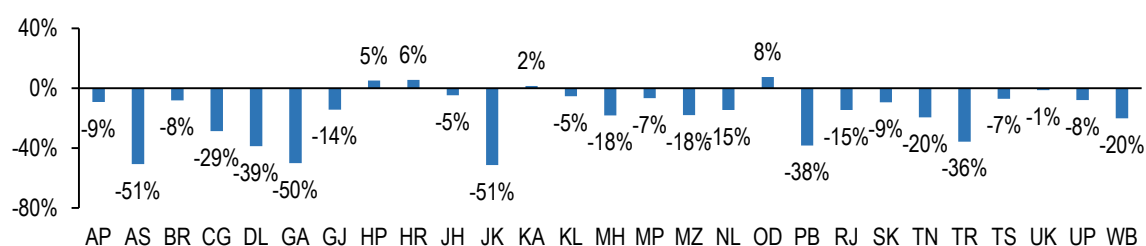
- GST compensation requirements increasing:** GST compensation requirements of states are increasing at faster rates than the compensation cess collections which finance them. This could lead to a scenario in the future when cess collections may not be sufficient to provide compensation to states. In 2019-20, cess collections have so far seen a growth of 1.5% during the seven-month period April to October 2019, which is much lower than the 21% growth budgeted for the year. Also, states have been guaranteed compensation only for a period of five years, which will end in 2022. After 2022, states receiving compensation will have a revenue gap as they will not get these funds. States have roughly 2.5 years to bridge this gap with other sources to avoid any potential loss in revenue (page 2).

Figure 1: Increasing compensation requirements vis-a-vis cess collections



- 15th Finance Commission:** The 15th Finance Commission's Terms of Reference were amended in July 2019 to require it to examine whether a separate funding mechanism for defence and internal security should be set up, and if so, how it can be operationalised. In 2019-20, the central government has estimated Rs 5,11,610 crore of expenditure on defence and internal security (18% of its budget). If the 14th Finance Commission had recommended the funding of this entire expenditure out of the divisible pool, devolution to states would have been lower by 7% of their 2019-20 revenue. Note that the 15th Finance Commission has not yet made any recommendation in this regard (page 4).
- States cutting their capital outlays:** States face a shortfall in their receipts (9% during the 2015-18 period), due to which they cut back their budgeted expenditure (as borrowing is also limited). Capital outlay by states sees higher underspending (14%) as compared to revenue expenditure (7%). Note that states' share in governmental capital outlay is significantly higher than the centre. In 2019-20, capital outlay by states on aggregate is estimated to be 2.8% of GDP (Rs 5.7 lakh crore), much higher than that by the centre (1.8% of GDP or Rs 3.8 lakh crore) (page 5).

Figure 2: States spent 14% less than what they budgeted for capital outlay during 2015-18



- States increasingly adopting Income Support Schemes:** Between 2018-19 and 2019-20, six states have announced income support schemes which involve direct cash transfer to targeted beneficiaries. While most of these schemes are targeted towards farmers, certain schemes also cover other sectors such as education, social welfare, and transport (page 6).
- Farm loan waivers have increased debt burden:** Farm distress has led to declaration of farm loan waivers by 10 states, amounting to Rs 2,63,260 crore. The loan waivers have increased debt burden on these states. States are implementing them over several years to limit the impact on fiscal deficit. As of 2019-20, Rs 1,08,843 crore is still to be disbursed for the waivers (page 7).
- Taking over discoms' losses under UDAY may impact states:** Under UDAY, 15 states took over debt of about Rs 2.1 lakh crore from their discoms in 2015-17. UDAY also requires states to progressively fund greater share in losses of discoms (10% in 2018-19, 25% in 2019-20, and 50% in 2020-21). If discoms are not able to cut their losses, it could significantly impact states in the near future (page 8).

States' GST compensation requirements increasing; 14% assured growth benefit to end in 2022

With GST implementation in 2017, the principle of indirect taxation for many goods and services changed from origin-based to destination-based. This means that the ability to tax goods and services and raise revenue shifted from origin or producing states to destination or consuming states. This, along with changes in the GST rates from the earlier tax rates, led to revenue uncertainty for states. This uncertainty was addressed through constitutional amendments and the GST (Compensation to States) Act, 2017, which guarantee states compensation for five years for any loss of revenue arising due to GST implementation. Compensation to states is given out of the GST Compensation Fund, which consists of collections of a cess levied specifically to generate funds for this purpose.

Figure 3 shows the compensation provided to states vis-à-vis cess collections during the period 2017-18 to 2019-20. In 2019-20, while cess collections are estimated to increase by 21% over the previous year, compensation requirement of states is estimated to increase at a much faster rate of 52%. Such difference in growth rates could lead to a scenario in the future where the cess collections may not be sufficient for the compensation requirements of states. This could occur in the year 2019-20 itself, as the growth of cess collections so far has been much lower than expected for the year (i.e., 1.5% growth witnessed during the seven-month period April to October 2019 vis-a-vis 21% growth budgeted for the complete year).¹

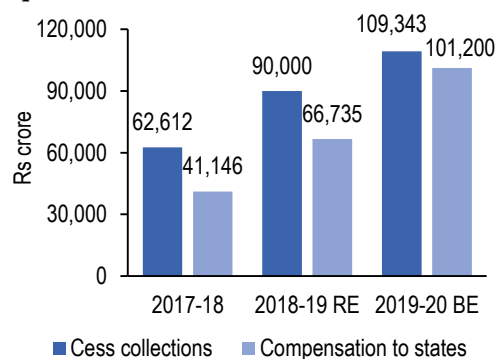
If the 1.5% growth rate prevails for the entire year, this could lead to a shortfall of nearly Rs 18,000 crore in the cess collections in 2019-20. Note that the central government could pay compensation to states from the current year's cess collections, and also from any unutilised money accumulated in the Compensation Fund from previous years. The GST (Compensation to States) Act provides that the GST Council can recommend other funding mechanisms for the Compensation Fund. For instance, this can be done when there is a shortfall of money in the Fund for providing compensation to states.

The situation could worsen further if the compensation requirement of states increases beyond the budgeted estimates. The Act guarantees states a 14% annual growth on their base year revenue, i.e., the revenue generated by states in 2015-16 through levy of taxes which were subsumed under GST. If the GST revenue of states do not match the guaranteed growth, compensation grants are provided to meet the shortfall. This implies that if the said growth rate decreases, compensation requirements will increase further. If states witness a growth lower than the growth rates estimated for 2019-20, their compensation requirements will further increase beyond the budgeted estimates for the year.

Note that the 14% annual growth rate assured under the Act is higher than the year-on-year nominal GDP growth as estimated by the central government (11.5%) and most states for the year 2019-20. Further, while the central government's GST revenue is estimated to grow at a rate of 13.6% in 2019-20 (as per the provisional actual figures for 2018-19), the actual growth could differ from the budget estimates. For instance, in 2018-19, the GST revenue of the central government was Rs 1.6 lakh crore (22%) lower (as per provisional actuals) than the estimate made in the budget.² While this shortfall indicates overall lower GST collections in the country, it also affects the devolution receipts of states. A lower growth rate of central GST revenue would affect the share each state gets out of this pool.

In 2019-20, states' compensation requirement is estimated to be Rs 1,01,200 crore. States have been guaranteed compensation only for a period of five years, which is going to end in 2022. This implies that after 2022, states receiving compensation will have a revenue gap as they will not get these funds, which amount to more than one lakh crore rupees in 2019-20. Note that based on the present trends, this gap could increase significantly by 2022, when compensation is going to be discontinued. States have roughly 2.5 years to bridge this gap with other sources to avoid any potential loss of revenue.

Figure 3: Increasing compensation requirements vis-a-vis cess collections



Note: 2017-18 data corresponds to eight months of GST.
Sources: Union Budget Documents; PRS.

Table 1 below shows the compensation grants estimated by states for the years 2018-19 and 2019-20. Note that a lack of uniformity across states in reporting GST components, especially integrated GST and compensation, makes it difficult to compare across states.

Table 1: GST compensation grants expected by states for 2018-19 and 2019-20 (in Rs crore)

State	2018-19		2019-20	
	Amount	As a % of revenue	Amount	As a % of revenue
Assam	1,000	1%	1,000	1%
Bihar	3,698	2%	3,500	2%
Chhattisgarh	3,700	5%	4,506	6%
Delhi	3,500	8%	3,000	6%
Goa	0	0%	505	4%
Gujarat	6,547	5%	7,301	5%
Himachal Pradesh	2,702	9%	2,900	9%
Haryana	2,800	4%	3,000	4%
Jharkhand	700	1%	258	0%
Jammu and Kashmir	2,592	4%	2,954	4%
Karnataka	10,800	7%	17,249	9%
Kerala	2,100	2%	0	0%
Madhya Pradesh	0	0%	3,300	2%
Odisha	4,074	4%	4,867	4%
Punjab	9,375	13%	8,619	11%
Rajasthan	2,825	2%	405	0%
Sikkim	111	2%	235	3%
Tamil Nadu	4,238	2%	5,582	3%
Tripura	160	1%	182	1%
Telangana	500	0%	0	0%
Uttarakhand	0	0%	3,017	8%
Uttar Pradesh	6,495	2%	6,369	2%
West Bengal	1,990	1%	2,000	1%
Total	69,907	2%	80,751	3%

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.

Any change recommended by 15th FC to divisible tax revenue pool could affect states' revenue

The Finance Commission recommends the share of states in the divisible pool of central tax revenue. The 14th Finance Commission (2015-20) increased this share from 32% to 42%. The 15th Finance Commission was constituted in November 2017 to give recommendations for the period 2020-25.³ In October 2019, the 15th Finance Commission's period was extended by one year to also include the financial year 2025-26.⁴ With 2019-20 being the last year of the 14th Finance Commission period, the Terms of Reference of the 15th Finance Commission and its recommendations will direct a major share of states' revenue (35% average in 2015-20) during the six-year period 2020-26.

Defence and internal security: The 15th Finance Commission's Terms of Reference were amended in July 2019 to require it to examine whether a separate funding mechanism for defence and internal security should be set up, and if so, how it could be operationalised. In 2019-20, the central government has estimated an expenditure of Rs 4,31,011 crore on defence and Rs 80,599 crore on internal security (central armed police forces, intelligence bureau, and border infrastructure). This amounts to an expenditure of Rs 5,11,610 crore in 2019-20 on defence and internal security, i.e., 18% of the central government's budget.

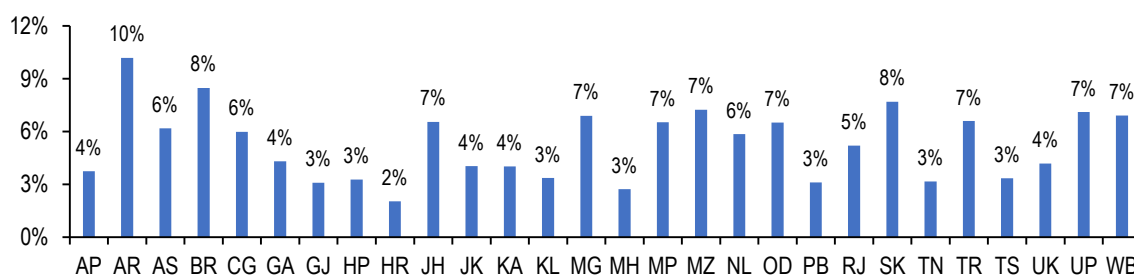
If the 15th Finance Commission recommends a mechanism which involves setting aside funds for this purpose from the divisible pool, it would affect the devolution receipts of states in the future. For instance, if the 14th Finance Commission had recommended the funding of this entire expenditure out of the divisible pool, devolution to states would have been lower by 7% of their 2019-20 revenue. Note that the 15th Finance Commission has not yet made any recommendation in this regard.

Cess and surcharge: The 15th Finance Commission's Terms of Reference require it to recommend the share of centre and states in the divisible pool, which is made up of net proceeds of taxes required to be, or which may be, divided between them as per the Constitution. Article 270 of the Constitution specifies the taxes which form the divisible pool. It does not include any cess or surcharge levied by the central government. Therefore, the central government is not required to share with states the revenue it gets from cesses and surcharges.

RBI (2019) observed that the share of revenue from cess and surcharge in the central government's gross tax revenue has increased from 2.3% in 1980-81 to 15% in 2019-20.⁵ This implies that of the total tax revenue that the central government collects, the part that is not required to be shared with states has increased over the years. As a result, only 85% of the central government's gross tax revenue in 2019-20 could form the divisible pool. This implies that states' 42% share in the divisible pool, as recommended by the 14th Finance Commission, effectively comes down to 35.7% of centre's tax receipts in 2019-20 (for calculating the effective share, we exclude GST components from tax revenue such as integrated GST and compensation cess).

The central government has estimated Rs 3,69,111 crore revenue through cesses and surcharges in 2019-20. If this tax revenue collected by the central government was a part of the divisible pool, it would have increased the devolution receipts of states. On average, states would have received an additional revenue equivalent to 5% of their 2019-20 revenue, if this cess and surcharge revenue was in the divisible pool. Figure 4 shows the state-wise increase as a percentage of their 2019-20 revenue.

Figure 4: Possible increase in states' revenue if cess and surcharge were in the divisible pool (2019-20)

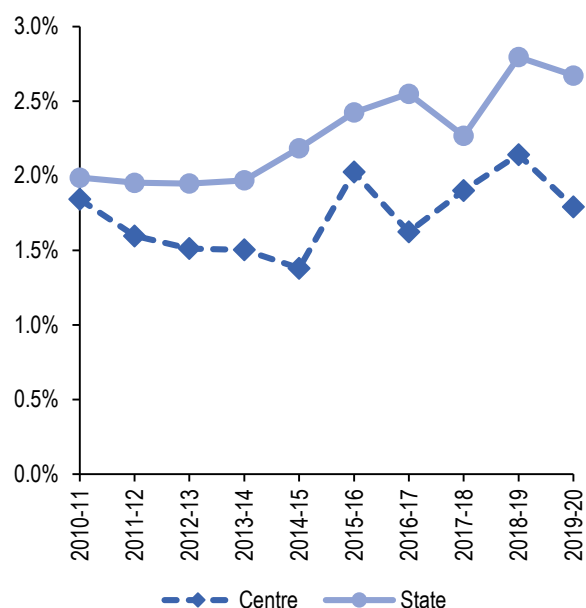


Sources: Union and State Budget Documents; RBI State of State Finances 2019-20; PRS.

States underspending more on capital outlay than on other components of the budget

Capital outlay is the component of government's expenditure which leads to creation of assets such as roads and bridges, schools, and hospitals. During the 2010-20 period, the states on aggregate have spent higher on capital outlay as compared to the centre (Figure 5). For instance, in 2019-20, capital outlay of states on aggregate and the centre is estimated to be 2.8% of GDP (Rs 5.7 lakh crore), and 1.8% of GDP (Rs 3.8 lakh crore), respectively. The size of the expenditure budget of states has increased over the years owing to revenue augmentation by the states as well as increased devolution from the centre. The gap between a government's expenditure and receipts is funded through borrowings which is subject to limits under the FRBM framework. States have managed to keep revenue deficit under control (0.1% during the 2015-18 period) unlike the centre (2.4% during the same period). Consequently, states have had more funds for capital outlay.

Figure 5: Capital outlay by states and centre as a percentage of GDP (2010-20)



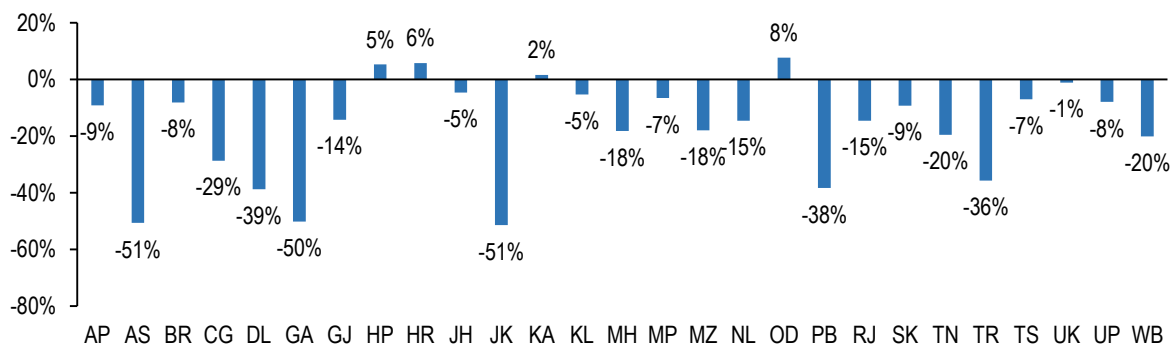
Note: Data for states does not include Arunachal Pradesh, Meghalaya, Manipur, and Puducherry.

Sources: Union and State Budget Documents; PRS.

Given the increasingly higher share of states in capital outlay in the country, it is important to note that cutback in capital outlay by states has been more than other components of their budget. During the 2015-18 period, the spending on capital outlay by states was 14% less than what they budgeted. In comparison, the cutback in revenue expenditure was 7%. As the actual receipts have been significantly lower (9% on average during the 2015-18 period), the states have had to cut back their expenditure in order to meet fiscal deficit targets. During this period, committed expenditure items comprising salaries, pensions, and interest payments have formed 53% of the revenue expenditure. These are expenditure obligations which are difficult to reduce during the year. As revenue expenditure is less compressible, a disproportionate cutback is observed in capital outlay.

During the 2015-20 period, four states have on average spent more on capital outlay than they budgeted (Figure 6). These include Odisha (8%), Haryana (6%), Himachal Pradesh (5%), and Karnataka (2%). States which ended up spending significantly less than what they budgeted include Jammu and Kashmir (51%), Assam (51%), and Goa (50%).

Figure 6: States spent 14% less than what they budgeted for capital outlay during 2015-18



Sources: State Budget Documents; PRS.

Expenditure by states on farm loan waivers have impacted their finances

Farm loan waivers given by states require them to take over farmers' debts. 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 2 and Figures 7 and 8 show details of the farm loan waivers announced by states and the expenditure made so far.

Table 2: Farm loan waivers announced by states since 2014-15 (figures in Rs crore)

State	Year of announcement	Amount announced	Expenditure (till date)	Pending amount
Andhra Pradesh	2014-15	24,000	12,731	11,269
Telangana	2014-15	17,000	21,473	27,527
Tamil Nadu	2016-17	5,280	5,243	37
Maharashtra	2017-18	34,020	21,925	12,095
Punjab	2017-18	10,000	8,848	1,152
Uttar Pradesh	2017-18	36,360	27,202	9,158
Karnataka	2018-19	44,000	28,532	15,468
Chhattisgarh	2018-19	6,100	9,223	-3,123
Madhya Pradesh	2018-19	36,500	13,000	23,500
Rajasthan	2018-19	18,000	6,240	11,760
Total		2,63,260	1,54,417	1,08,843

Sources: State Budget Documents; RBI State of State Finances 2019-20; PRS.

Announcement of loan waivers by states increased significantly in the years 2017-18 and 2018-19. While loan waivers of almost Rs 1.85 lakh crore were announced during these two years, the total expenditure on loan waivers by states in these two years was less than one lakh crore rupees. This includes the expenditure by three states which had started implementing loan waivers before 2017-18.

Since states implement loan waivers over several years, their impact on the state's annual finances or fiscal deficit (borrowing requirement in a year) depends on the number of years of implementation. States which choose to implement it in a single year see a large impact on fiscal deficit that year, in contrast to a staggered implementation. Loan waivers could have varying impacts, depending on the amount of loans waived, the manner of implementation, and that particular state's fiscal condition. Nonetheless, the loan waiver amount directly increases a state's outstanding debt, if it is financed through borrowings. Thus, the larger the loan waiver amount, the higher is its debt burden.

Financing of farm loan waivers may be relatively easier for states which are in better fiscal shape. This means that it may be easier for states whose lower fiscal deficit levels give them enough fiscal space to implement loan waivers without crossing the limits specified under the FRBM Act. On the other hand, states which are already expecting relatively higher fiscal deficit due to other requirements may find it difficult to accommodate the additional expenditure due to loan waiver.

The Union Agriculture Ministry observed that loan waivers may impact credit culture by incentivising defaulters, and by discouraging farmers who can repay or have made regular repayments.⁶ It noted that each waiver given makes it more difficult to reject future demands. An RBI Working Group constituted to review agricultural credit (2019) observed that loan waivers do not address underlying causes of farm distress and destroy credit culture, potentially harming farmers' interest in the medium to long term.⁷ It also noted that loan waivers squeeze the fiscal space available for making productive investment in agriculture. The Working Group recommended that: (i) loan waivers should be avoided, and (ii) the central and state governments should undertake a holistic review of agricultural policies and input subsidies in order to improve the overall viability and sustainability of agriculture.

Figure 7: Loan waivers announced

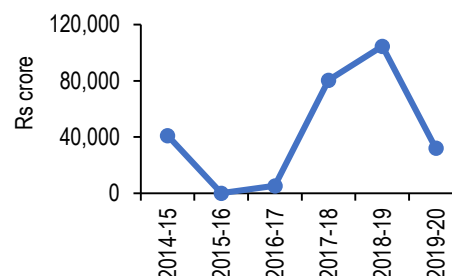
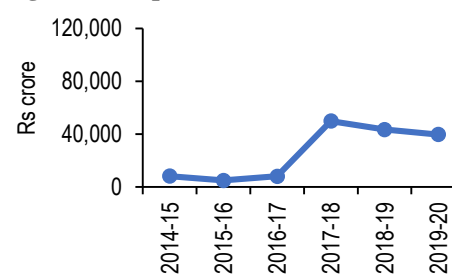


Figure 8: Expenditure on loan waivers



State governments are increasingly adopting income support schemes

In 2019, the central government announced Pradhan Mantri Kisan Samman Nidhi (PM-KISAN), a central sector scheme. This scheme provides an income support of Rs 6,000 per year to all farmer families. The scheme seeks to supplement their financial needs in procuring inputs for appropriate crop health and yields. The budget allocation for this scheme in 2019-20 is Rs 75,000 crore. Similar income support schemes have been announced by various state governments providing direct cash transfer to beneficiaries. Such schemes provide the beneficiaries agency to spend as per their choice. These schemes seek to extend benefit by increasing the purchasing power of beneficiaries in place of providing subsidized goods or services.

The income support schemes being implemented by the states in their current form are targeted schemes. It implies that the benefit is extended to persons satisfying a set of selected criteria. Most of these schemes have been announced in the agriculture sector. Such schemes have been allocated a significant portion of the sectoral budget. For instance, in 2019-20, 43% of the agriculture budget was allocated to the income support scheme for farmers in Andhra Pradesh. Table 3 provides an illustrative list of such schemes announced by various state governments during recent years.

Table 3: Some recent income support schemes announced by various state governments

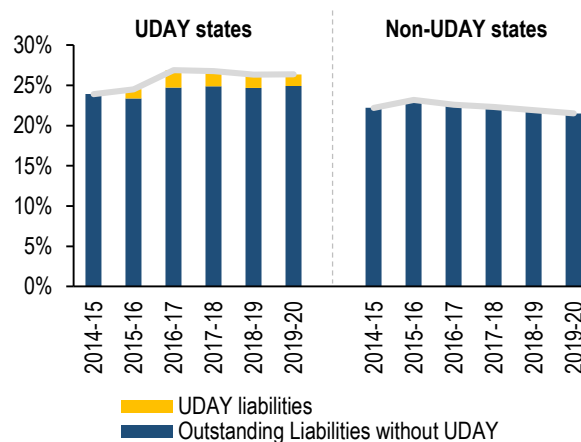
State	Scheme	Sector	Benefit	Year of announcement	2019-20 BE (in Rs crore)	% of sectoral budget
Andhra Pradesh	YSR Rythu Bharosa	Agriculture	Farm investment support of Rs 7,500 per year to farmers, including tenant farmers	2019-20	8,750	43%
Andhra Pradesh	Jagananna Amma Vodi	Education	Rs 15,000 per year to mothers sending their children to school	2019-20	6,456	19%
Andhra Pradesh	Jagananna Vidya Deevena	Social Welfare	Maintenance support of Rs 20,000 per year to students from SC, ST and other weaker sections of the society	2019-20	4,962	18%
Andhra Pradesh	YSR Vaahana Mitra	Transport	Financial assistance of Rs 10,000 per year to auto and taxi drivers	2019-20	400	9%
Haryana	Mukhyamantri Parivar Samman Nidhi	Agriculture	Financial support of Rs 6,000 per year to small and marginal farmers and workers in unorganized sectors	2019-20	1,500	33%
Jharkhand	Mukhyamantri Krishi Aashirvaad Yojana	Agriculture	Farm investment support of Rs 5,000 per acre per year to farmers	2019-20	2,000	40%
Odisha	Krushak Assistance for Livelihood and Income Augmentation (KALIA)	Agriculture	A financial assistance of Rs 25,000 over five agricultural seasons to small and marginal farmers, sharecroppers and agricultural landless labourers	2018-19	5,611	43%
Telangana	Rythu Bandhu	Agriculture	Farm investment support of Rs 10,000 per acre per annum to farmers	2018-19	9,056	42%
West Bengal	Krishak Bandhu	Agriculture	Assured financial assistance of Rs 5,000 per annum for farmers with one or more acre landholding	2019-20	3,000	31%

Sources: State Budget Documents, Respective scheme websites; PRS.

Future takeover of losses under UDAY may impact state finances

In November 2015, the central government launched the Ujwal Discom Assurance Yojana (UDAY) to improve the financial as well as operational situation of state-owned power distribution companies (discoms). As of March 2015, the debt of the discoms stood at Rs 4.3 lakh crore.⁸ The financial stress had impacted the ability of discoms to provide adequate power at an affordable rate.⁸ In addition, default on debt by such discoms could have impacted the banking sector and the economy at large.⁸ Note that liabilities of the discoms are contingent liabilities of the respective states. States often provide guarantee for the loans taken by such state-owned enterprises. By shifting the debt from these enterprises to government accounts, the liabilities of the state governments are more accurately shown.

Figure 9: Impact of UDAY scheme on outstanding liabilities of the states



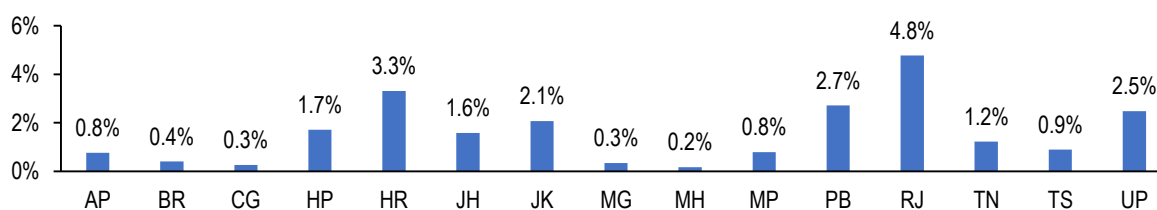
Note: Data includes all 28 states, Delhi, erstwhile state of Jammu and Kashmir, and Puducherry. UDAY states implies the 15 states which took over debt of their DISCOMs.
Sources: RBI State of State Finances 2019-20; PRS.

The states signing up for the UDAY scheme for debt restructuring of discoms were required to take over 75% of the discoms' debt over a period of two years (50% in 2015-16 and 25% in 2016-17). 15 states took over debt of their discoms which added about Rs 2.1 lakh crore to their outstanding debt. At the end of 2016-17, the share of UDAY liabilities in total outstanding debt of these 15 UDAY states on aggregate was 2.2% of their GSDP. Figure 9 shows the share of outstanding UDAY liabilities in the total outstanding debt of states at the end of the year (2014-20).

Impact of UDAY scheme on the finances of these states will continue beyond 2016-17 in the form of interest payment on these liabilities, and future repayment of these liabilities. The UDAY liabilities of the states on aggregate is estimated to be 1.5% of their GSDP at the end of 2019-20. States such as Rajasthan (4.8%), Haryana (3.3%), Punjab (2.7%), and Uttar Pradesh (2.5%) have higher UDAY liabilities than the average (Figure 10). UDAY requires states to progressively fund greater share in losses of discoms from their budgetary resources (10% in 2018-19, 25% in 2019-20, and 50% in 2020-21). As a result, states are estimated to provide funding of Rs 2,726 crore in 2018-19.⁵ Hence, if discoms are unable to cut down on their losses, impact of this provision on state finances will increase significantly in 2019-20 and 2020-21.⁵

Note that the finances of discoms are dependent on electricity tariffs. Despite the UDAY target of eliminating the gap between the cost of supplying power and the average revenue realised, the gap is Rs 0.38/unit as on December 2019.⁹ One of the key reasons behind this gap is under-priced tariffs for agricultural and residential consumers. As a result, outstanding dues of discoms have risen sharply in the recent period, after registering decline immediately post UDAY.⁵ At the end of October 2019, the overdue outstanding amount owed by the discoms to power producers was Rs 70,513 crore.¹⁰ Delayed payment to power producers can also have a wider impact on the economy including the finances of power producers. This may also result in an increase of non-performing assets of banks and adverse impact on the finances of their suppliers such as coal companies.

Figure 10: Outstanding UDAY liabilities as a percentage of GSDP in 2019-20



Sources: RBI State of State Finances 2019-20; PRS.

TRENDS IN STATE FINANCES

This section looks at the finances of the states and trends that have emerged in the 14th Finance Commission period (2015-16 to 2019-20) with respect to states' revenue, expenditure, and deficit.

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

Revenue receipts of states comprises revenue from own sources, and transfers from the centre. During the 2015-20 period, 53% of revenue receipts of states has come from own sources, and 47% from central transfers (Figure 11).

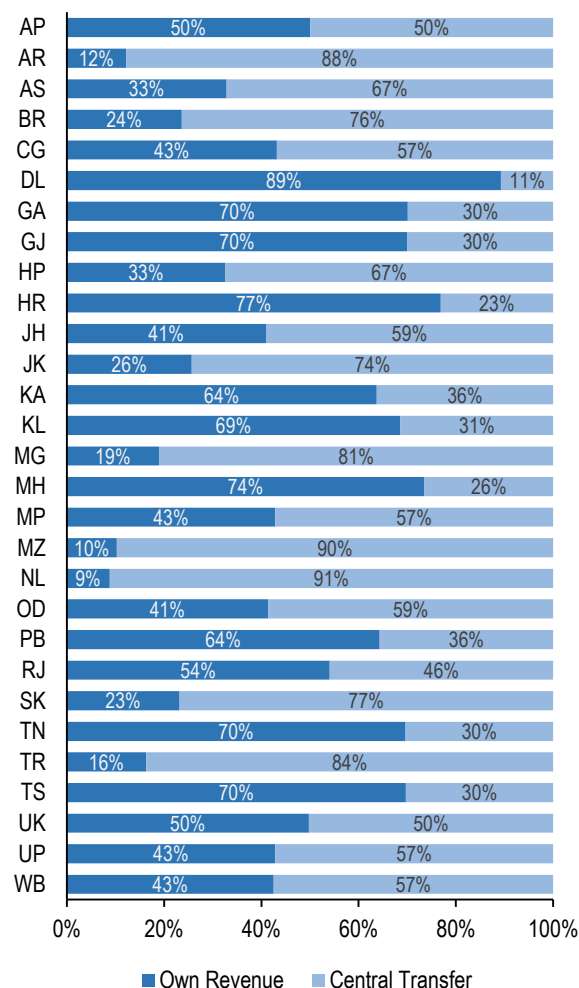
Own revenue consists of tax revenue (45%), and non-tax revenue (8%). Central transfers consist of share in central taxes (28%), and grants-in-aid from the centre (19%). As per the recommendations of the 14th Finance Commission, the share of states in union taxes was increased from 32% to 42% for the 2015-20 period. During the 13th Finance Commission Period (2010-15), the share of devolution of central taxes, and grants-in-aid from the centre in the revenue receipts of the states was at 22% and 17%, respectively.

The contribution of own revenue is significantly higher (more than 70% of total state receipts) in states such as Haryana, Maharashtra, Gujarat, Tamil Nadu, Telangana, and Delhi (Figure 11). On the other hand, states such as Bihar, Jammu and Kashmir, Himachal Pradesh and the north-eastern states depend on central transfers for most of their revenue.

Share of own non-taxes is in the range of 6-16% of total revenue in most states. Goa at 26% is an exception (electricity distribution in the state is through a government department unlike in other states).

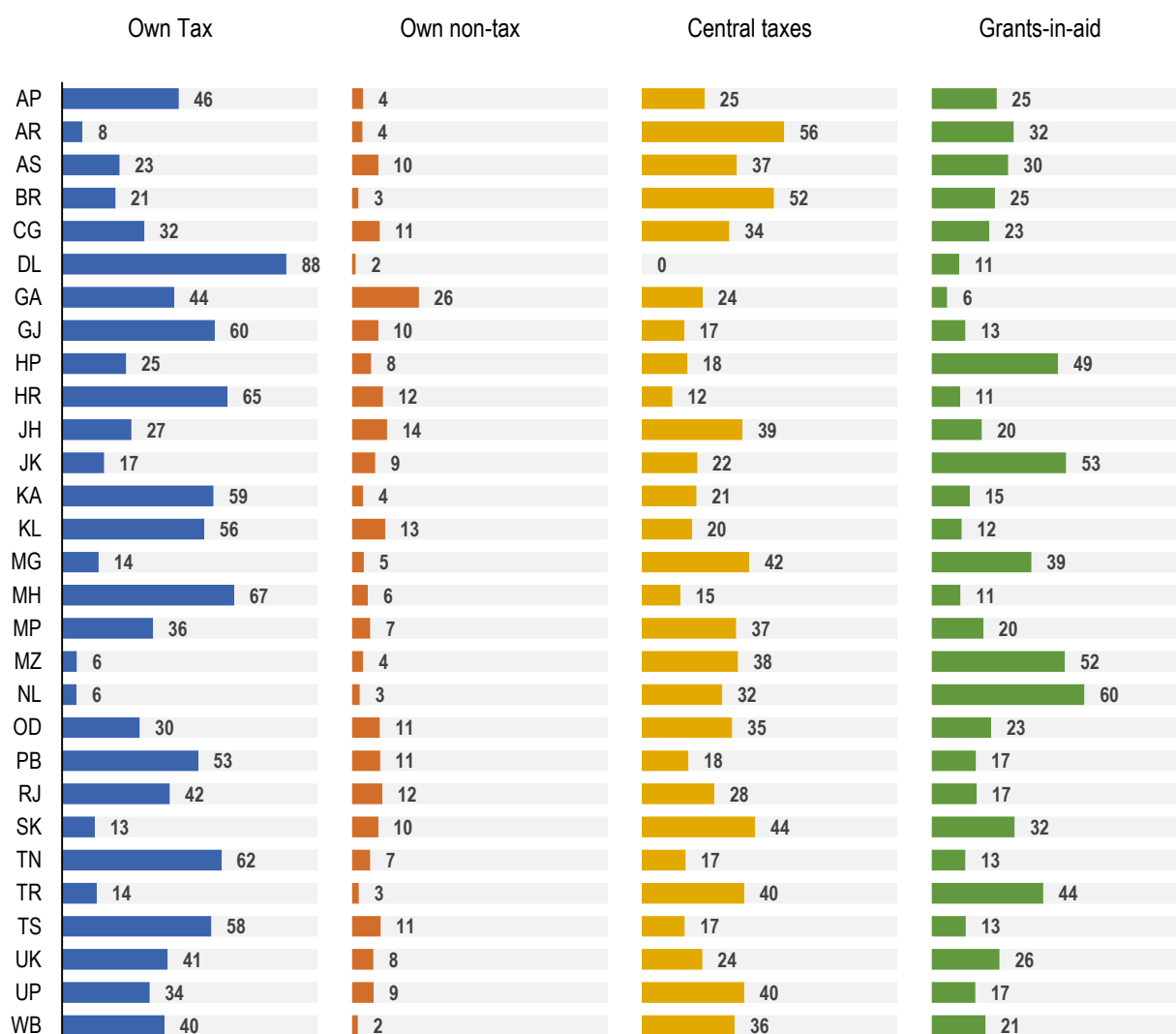
As can be seen in Figure 12 on the next page, states such as Himachal Pradesh, Jammu and Kashmir, and the north-eastern states are comparatively more dependent on the grants-in-aid from the centre. Unlike devolution, which is constitutionally provided as per the Finance Commission's criteria, most of 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 11: Composition of revenue receipts of states (2015-20)



Sources: State Budget Documents; PRS.

Figure 12: Share of components of revenue receipts in per cent (2015-20)



Note: As Delhi is a union territory, it does not have any share in the divisible pool of central taxes.

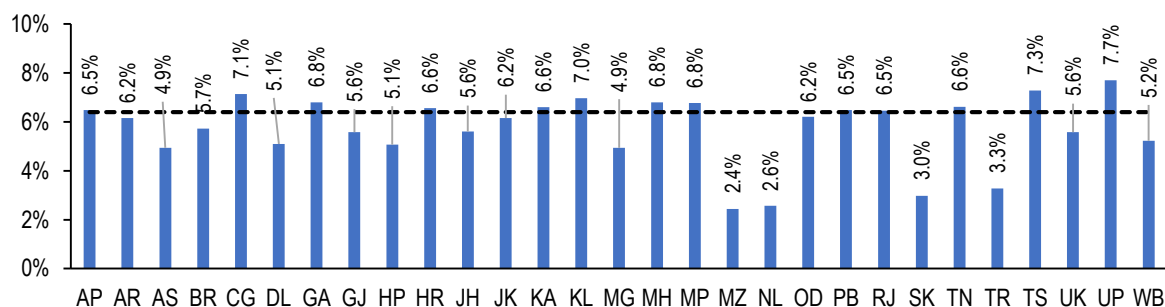
Sources: State Budget Documents; PRS.

Own tax revenue grows faster than GSDP for 13 states

As discussed earlier, own tax revenue has been the largest source of revenue (45% of total revenue) for states between 2015-20. 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 2015-16 to 2019-20 has been 6.4% (Figure 13). For most states, it ranges between 5%-8%. The ratio is lower than the average for the north-eastern states.

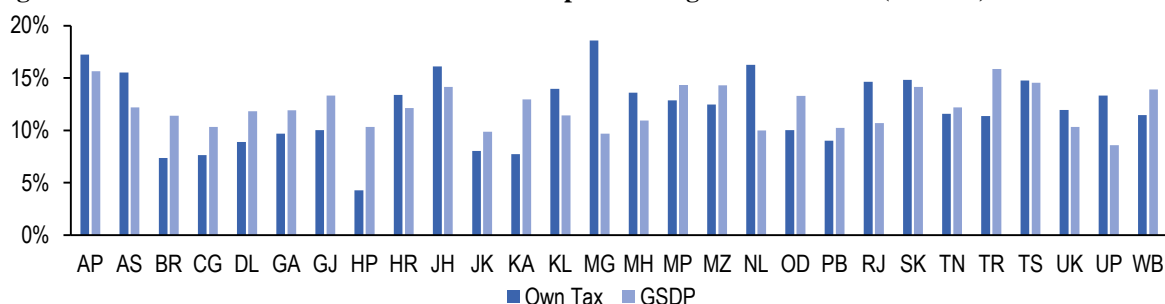
Figure 13: Own tax as a percentage of GSDP (2015-20)



Sources: State Budget Documents; PRS.

On average, own tax revenue of states has grown at a rate of 12% during 2015-20. While Meghalaya and Andhra Pradesh have comparatively higher growth rates at 19% and 17% respectively, Himachal Pradesh, Bihar, Chhattisgarh and Karnataka have witnessed comparatively lower growth rates (Figure 14). During 2015-20, for 13 out of the 29 states, the growth rate of own tax revenue has been greater than the GSDP growth rate. 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 14: Growth rate of own tax revenue in comparison to growth in GSDP (2015-20)

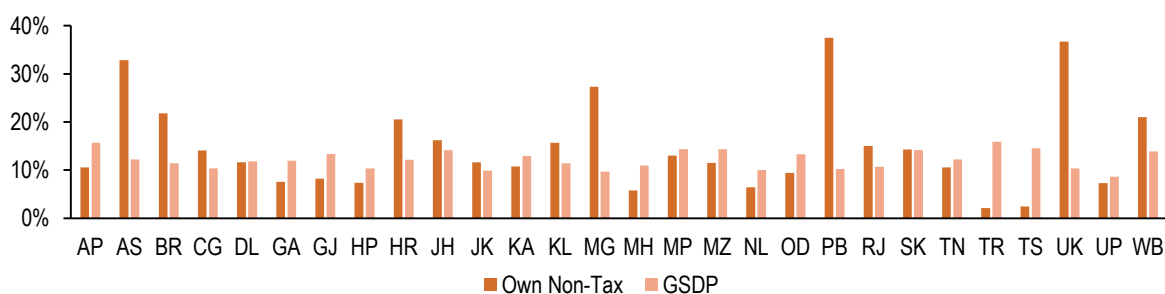


Sources: State Budget Documents; PRS.

Own non-tax revenue grows faster than GSDP for 14 states

During the 2015-20 period, 8% of the revenue receipts of states has come from own non-tax revenue sources. States earn non-tax revenue through various sources such as (i) royalty, (ii) interest earned on loans provided by states, (iii) dividend from public sector enterprises, (iv) lottery, and (v) various fees and fines. The average growth rate in own non-tax revenue of states has been 12% during this period. States such as Punjab (38%), Uttarakhand (37%), and Assam (33%) have grown at a higher rate in comparison to others (Figure 15). In 14 states, own non-tax revenue has grown at a higher rate than their GSDP. Tripura and Telangana (2% each) are among the states which have seen the lowest average growth in non-tax revenue during the 2015-20 period.

Figure 15: Growth rate of own non-tax revenue as compared to growth in GSDP (2015-20)



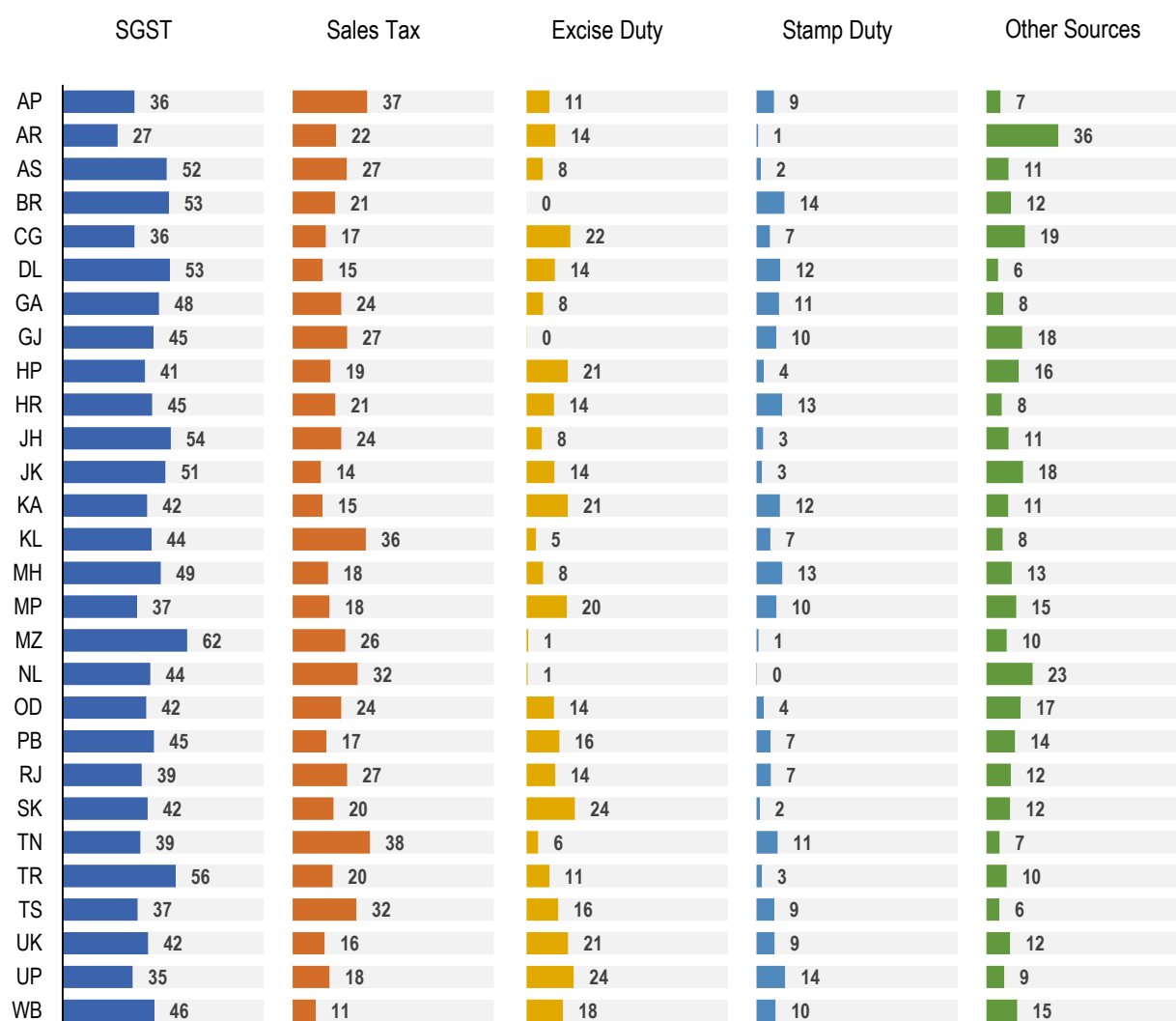
Note: High growth rate of own non-tax revenue of Punjab and Uttarakhand is mainly due to a sharp increase in estimates of revenue from general services in 2019-20. High growth rate of Assam is due to an increase in non-tax revenue from petroleum and other sources.
Sources: State Budget Documents; PRS.

SGST is the largest source of own tax revenue for states

Own tax revenue of states can be categorized as direct taxes and indirect taxes. Direct taxes include taxes on income and property whereas indirect taxes include taxes on commodities and services. Key sources of direct taxes for states are: (i) taxes on agricultural income, (ii) land revenue, and (iii) stamp duty and registration fees. Currently, agricultural income tax is exempted from income tax, irrespective of the level of income, except those on plantations levied by states like Assam.⁵ Key indirect taxes include: (i) state goods and services tax (SGST), (ii) sales tax/value added tax (VAT) on alcohol and petroleum products, (iii) state excise duty on alcohol, (iv) taxes on vehicles, and (v) taxes and duties on electricity. More than 75% of own tax revenue of the states come from indirect taxes.

SGST: In 2019-20, SGST is estimated to be the largest source of own tax revenue of states (43%) (Figure 16). 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. Consequently, states have limited autonomy on a large part of its own tax revenue as the receipts from SGST depend on tax rates decided by the GST Council. States such as Jammu and Kashmir, Mizoram, and Tripura are estimated to receive more than 50% of their own tax revenue from SGST in 2019-20.

Figure 16: Share of key taxes in own tax revenue in per cent (2019-20)



Note: Meghalaya is not included in the figure as the SGST numbers are not given in the budget document. Due to alcohol prohibition in place in Bihar and Gujarat, revenue from excise duty is nearly zero.

Sources: State Budget Documents; PRS.

After SGST, the **sales tax/VAT** (23%), and the **state's excise duty** (13%) are among the largest sources of revenue for the states. Sales tax/VAT and excise duty mainly come from these taxes on petroleum products and alcohol (these two products are not part of the GST system). Share of sales tax/VAT in own tax revenue of states such as Kerala, Tamil Nadu, and Andhra Pradesh is higher than the average. Some states have been considering alcohol prohibition which may lead to loss of tax revenue from the state's excise duty. For instance, Bihar enforced alcohol prohibition from April 1, 2016. During the previous year, i.e., 2015-16, state's excise duty contributed 12.3% of the total own tax revenue of Bihar (Rs 3,142 crore), which came down to nearly zero in the following years.

Stamp duty and registration fee applicable on transfer or sale of property is another major source of revenue for states, which is estimated to contribute 10% to the own tax revenue in 2019-20. The revenue from this source depends on the tax rates and the valuation of the property on which these rates are applied. The valuation of a property, in turn, depends on the land rates approved by states from time to time. In 2019-20, RBI observed that the approved land rates in most states are not market-determined.⁵ Independent and market-related valuation of properties can help states in increasing revenue from this source.⁵

Taxes on vehicles (6%), and **electricity** (3%) are among other important sources of own tax revenue. Contribution of taxes and duties on electricity is estimated to be higher than average in states such as Chhattisgarh (9%), Gujarat (9%), and Odisha (8%). Contribution of taxes on vehicles for most states is estimated to be between 5%-7%.

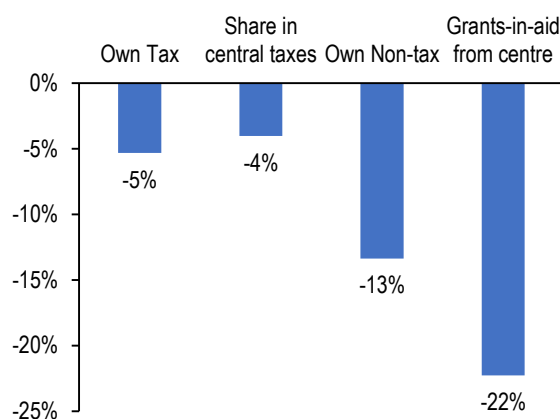
States raise 9% less revenue than budgeted, higher shortfall in grants-in-aid from the centre

During the 2015-18 period, states raised 9% less revenue than their budget estimates. Such a scenario would require states to either cut their expenditure or increase their borrowings to compensate for their shortfall in receipts.

Among the four broad categories of revenue receipts, higher shortfall is seen in grants-in-aid from the centre (22%), and own non-tax revenue (13%) (Figure 17).

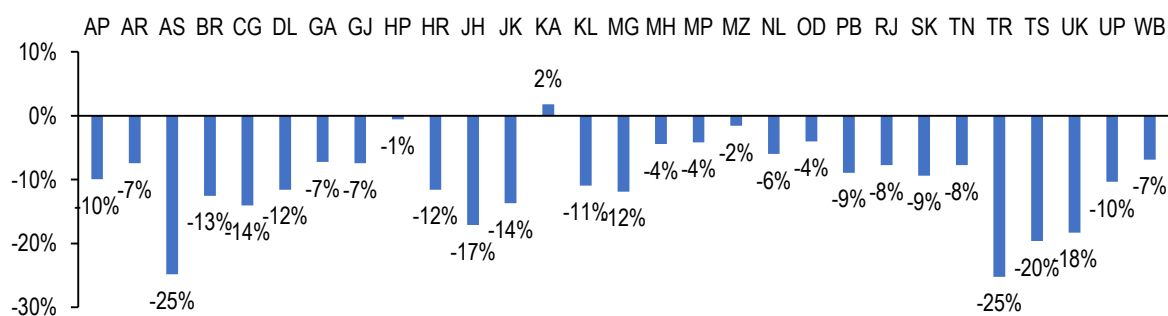
During the 2015-18 period, states such as Assam (25%), Tripura (25%), and Telangana (20%) have seen higher shortfall in revenue as compared to other states (Figure 18). The average revenue receipts of Karnataka have been 2% more than the budget estimates during this period.

Figure 17: Category wise shortfall in revenue receipts of states as compared to BE (2015-18)



Sources: State Budget Documents; PRS.

Figure 18: Shortfall in revenue receipts of states (2015-18)

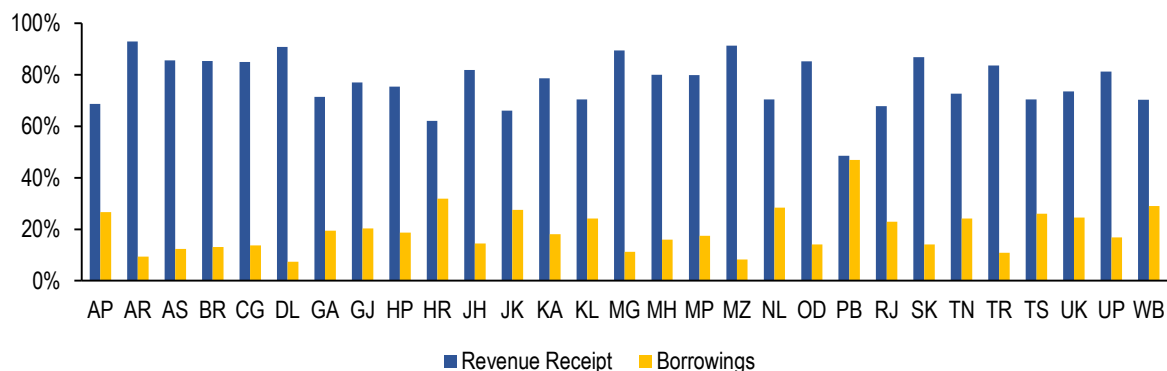


Sources: State Budget Documents; PRS.

States finance 75% of their expenditure through revenue receipts; 21% from borrowings

Revenue receipts are the major source of funds for states to finance their expenditure (75% during the 2015-20 period). States also rely on borrowings to finance their expenditure which is a part of capital receipts. During the 2015-20 period, 21% of the total expenditure of states has been met through borrowings. Capital receipts also include recovery of loans and advances given by states, money received from sale of assets such as land, and disinvestment. The share of capital receipts other than borrowings in meeting expenditure of the states is small (4%). During this period, states such as Punjab (47%), Haryana (32%), and West Bengal (29%) have had much higher reliance on borrowings to meet their expenses as compared to other states. Less than 10% of the total expenditure of states such as Delhi, Mizoram, and Arunachal Pradesh has been financed through borrowings.

Figure 19: Financing of states' expenditure during the 2015-20 period

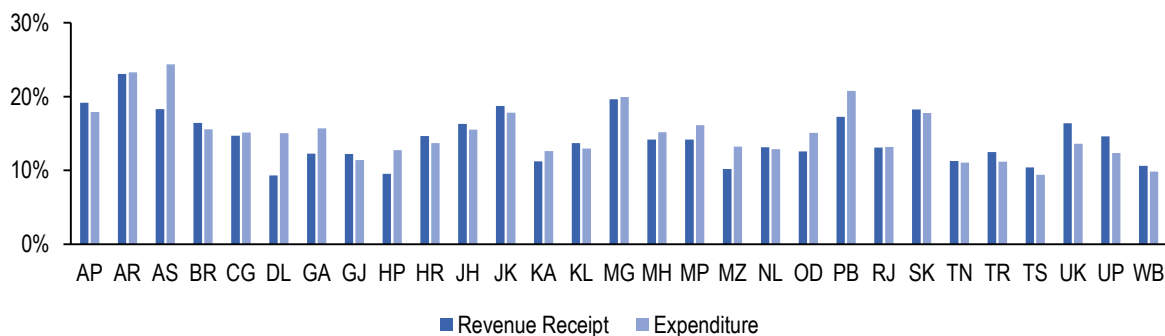


Note: The total expenditure includes repayment of debt, and loans and advances given by states.
Sources: State Budget Documents; PRS.

Expenditure of 14 states grew at a higher rate than their revenue receipts during 2015-20

States require borrowings to fund the shortfall in own receipts as compared to its spending requirements. Expenditure growing at a higher rate than receipts may lead to increased borrowing requirement in future. The receipts and expenditure of states on aggregate has grown at a similar rate during the 2015-20 period (14%). However, in the case of 14 out of 29 states, expenditure grew at a higher rate than revenue receipts (Figure 20). States such as Assam and Delhi have seen a higher growth in their expenditure as compared to their receipts. In case of some states such as Punjab where expenditure has grown at a higher rate than revenue receipts, reliance on borrowing is already higher than the average (Figure 19).

Figure 20: Growth rate of expenditure and revenue receipts of states during the 2015-20 period



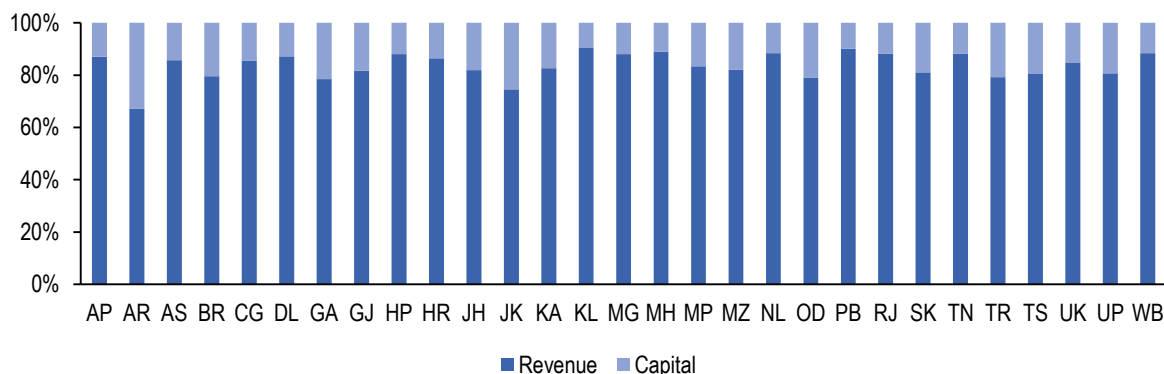
Note: Expenditure excludes debt repayment, and loans and advances given by the states.
Sources: State Budget Documents; PRS.

Revenue expenditure forms the bulk of total expenditure of all states

The expenditure of a government can be classified into two components: (i) revenue expenditure, and (ii) capital expenditure. Revenue expenditure is recurring in nature and includes expenditure on salaries, pensions, interest payment, and subsidies. Capital expenditure goes towards creating assets or reducing liabilities. Capital expenditure includes capital outlay which leads to the creation of assets such as schools, hospitals, and roads and bridges. Capital expenditure also includes repayment of loans (which lowers the state's liability burden), and loans and advances given by a government.

During the 2015-20 period, states on aggregate have incurred 85% of their expenditure on revenue component and 15% on capital outlay.

Figure 21: Composition of expenditure of states during the 2015-20 period



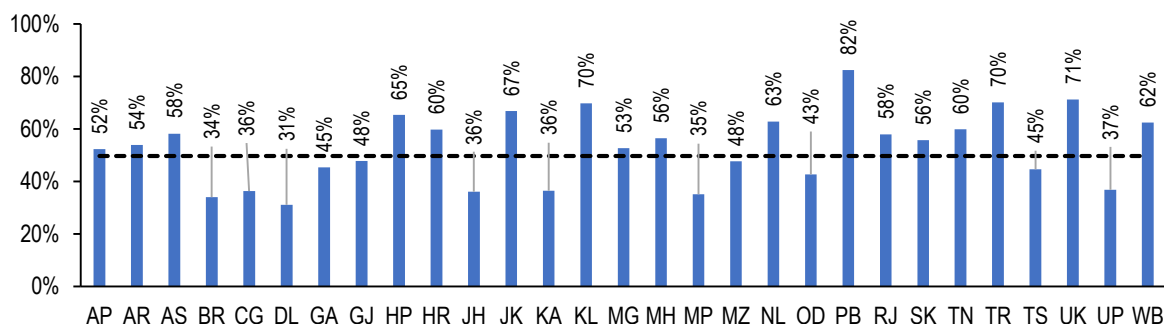
Note: Expenditure excludes debt repayment, and loans and advances given by the states.
Sources: State Budget Documents; PRS.

States spend 50% of its revenue receipts on committed expenditure items

Committed expenditure 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. During the 2015-20 period, the states on an average have spent 50% of their revenue receipts on committed expenditure (salaries, pensions, and interest payments) (Figure 22). 27% of the revenue receipts has been spent on salaries and wages, followed by 12% of the revenue receipts on interest payments and 11% of the revenue receipts on pensions.

Punjab (82%) spends the highest on committed expenditure, followed by Uttarakhand (71%), Tripura and Kerala (70% each). Spending of states such as Karnataka, Madhya Pradesh, Uttar Pradesh, and Bihar on committed expenditure is lower than the average. This is mainly due to a lower portion of revenue receipts being spent on salaries and wages.

Figure 22: Committed expenditure as percentage of revenue receipts (2015-20)



Sources: State Budget Documents; PRS.

Roads and bridges, irrigation and energy sectors receive the highest share of capital outlay

During the 2015-20 period, the states have spent the highest proportion of their capital outlay on roads and bridges (21%), irrigation (20%), and energy (11%) (Figure 23). When we compare the 2010-15 period with the 2015-20 period, the composition of capital outlay looks broadly similar. However, the share of irrigation sector has declined by 4% between these two periods.

Figure 23: Share of key sectors in capital outlay

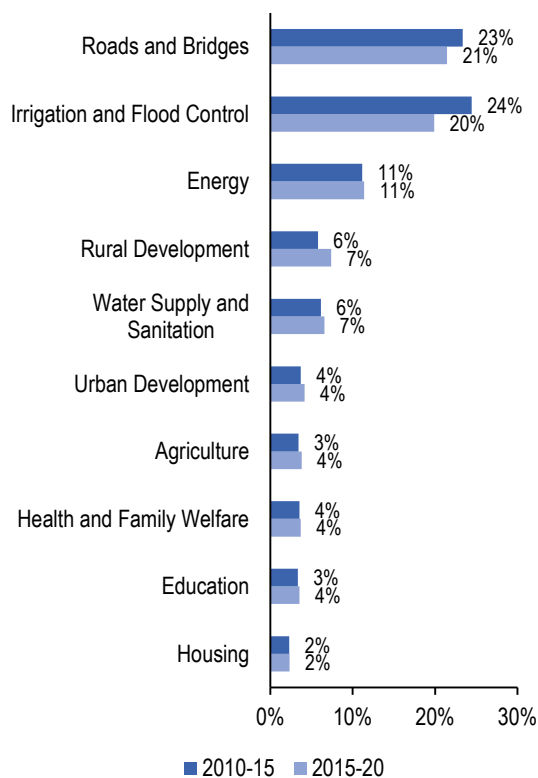
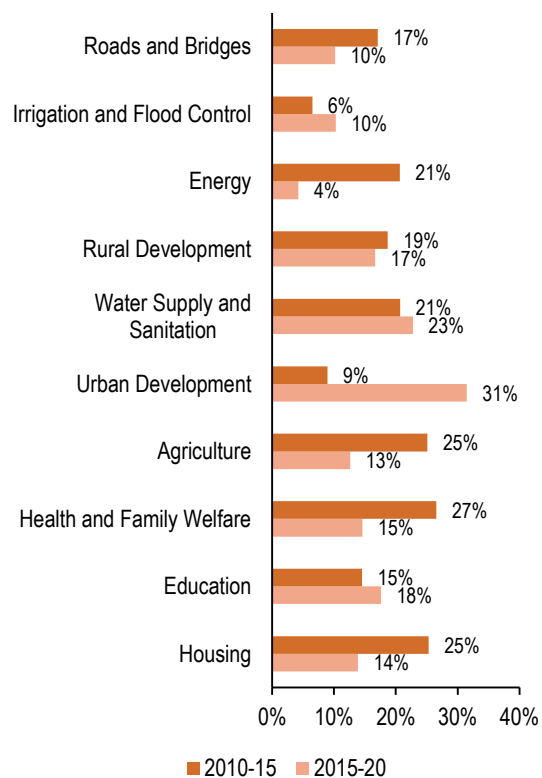


Figure 24: Growth in capital outlay on sectors



Sources: State Budget Documents; PRS.

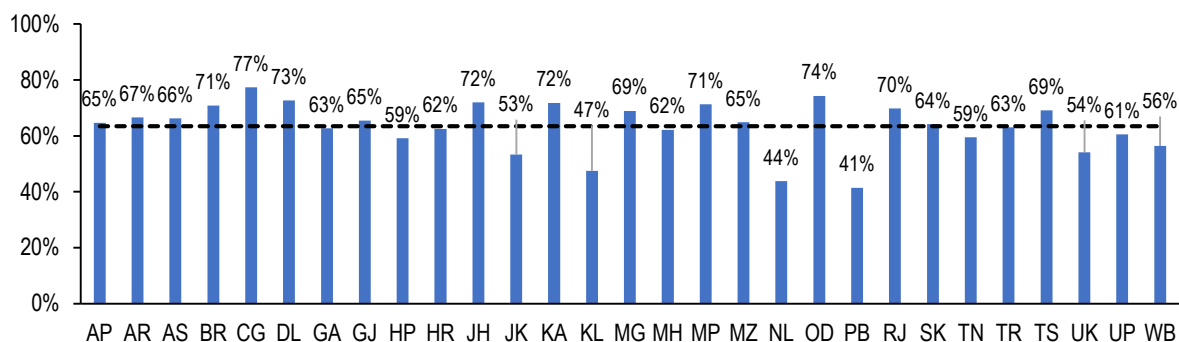
Sources: State Budget Documents; PRS.

Urban development (31%) and water supply & sanitation sectors (23%) have seen the highest annual growth during the 2015-20 period. Capital outlay in urban development has grown at 31% during the 2015-20 period as compared to 9% during the 2010-15 period. A notable decline in growth rate is seen in the energy sector where capital outlay has grown at 4% annually during the 2015-20 period. In comparison, capital outlay in energy sector had grown at 21% annually during the 2010-15 period. Details of the sector-wise capital outlay by individual states during the 2015-20 period are provided in the Annexure.

States spend 63% of its budget on developmental purposes

Another way to classify a government's expenditure is between developmental and non-developmental expenditure. A developmental expenditure helps in increasing the production and productivity of a state's economy. A developmental expenditure may involve both revenue expenditure and capital outlay. Developmental expenditure consists of: (i) social services, which includes expenditure on education, health, water supply and sanitation, housing, urban development, and welfare of backward communities, and (ii) economic services, which includes expenditure on agriculture and allied activities, rural development, irrigation, energy, and transportation infrastructure. Non-developmental expenditure consists of general services, which includes expenditure on administrative services, police, and payment of interest and pensions. On average, 63% of the budget of states was allocated towards developmental expenditure during 2015-20.

Figure 25: Developmental expenditure as a percentage of total expenditure (2015-20)

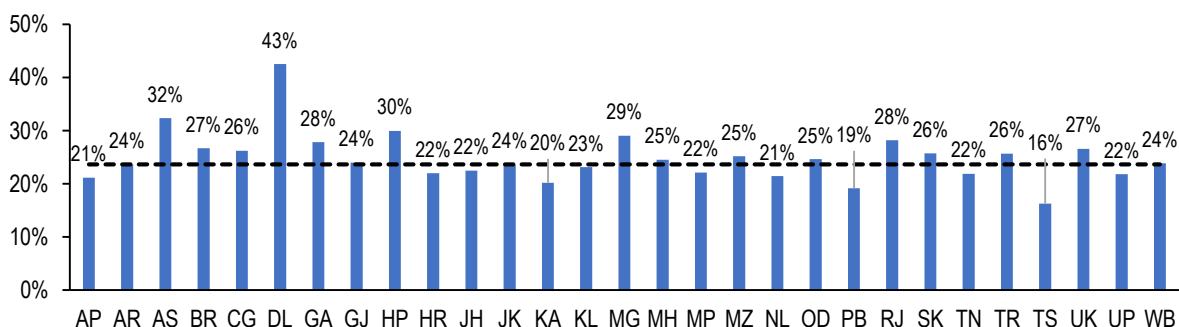


Sources: State Budget Documents; PRS.

States spend 24% of its budget 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 2015-16 to 2017-18, states on an average have spent 24% of their budget on human development (Figure 26). Within this, the highest allocation is towards education (16%), followed by health (5.3%), and the remaining 2.3% is for water supply and sanitation. During this period, Delhi has spent the highest on human development (43%) followed by Assam (32%), and Himachal Pradesh (30%).

Figure 26: Spending on human development as a percentage of total expenditure (2015-20)

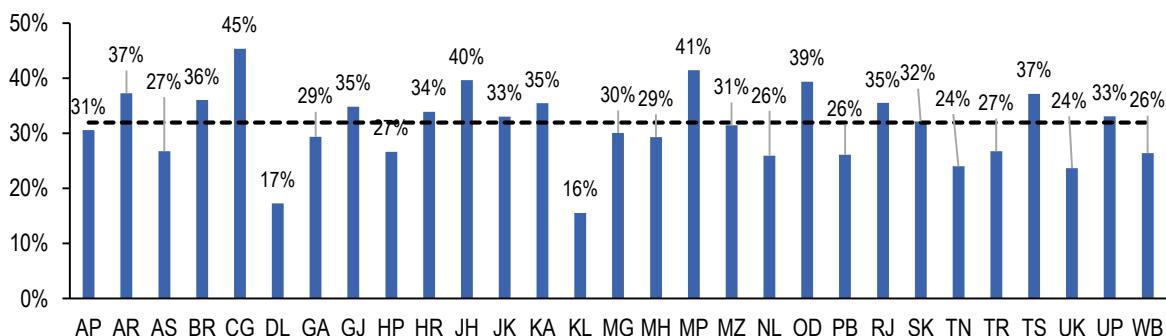


Sources: State Budget Documents; PRS.

States spend 28% of its budget on economic development

Expenditure on economic development comprises allocations made towards agriculture, irrigation, urban and rural development, housing, energy, and construction of roads and bridges. Expenditure on these sectors leads to the creation of infrastructure in the state, the benefits of which accrue to the state over the long term.

Figure 27: Spending on economic development by states as a percentage of total expenditure (2015-20)



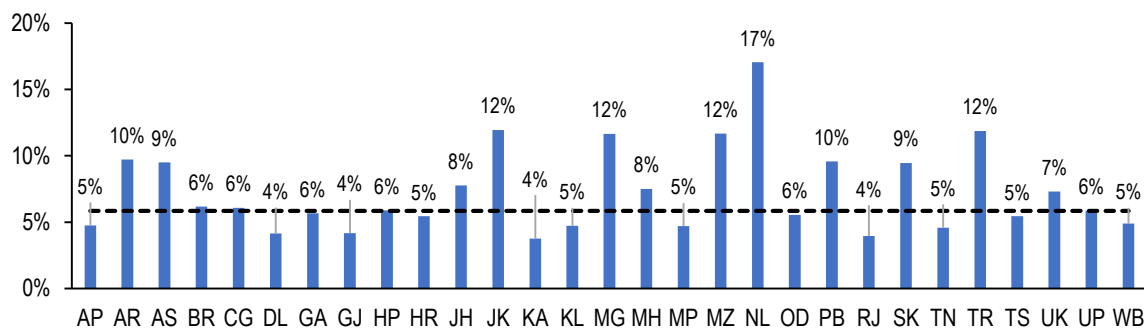
Sources: State Budget Documents; PRS.

Between 2015-16 and 2017-18, states on an average have spent 28% of their budget on economic development and infrastructure creation (Figure 27). During this period, Chhattisgarh spent the highest towards economic development and infrastructure creation (40%) followed by Madhya Pradesh (38%), and Telangana (36%).

States spend 6% of its budget on administration and security of citizens

During the 2015-20 period, states have spent 4% of their budget on police forces and 2% on administrative services, such as district administration, and public works (Figure 28). During this period, Nagaland has spent the highest on administration and security of citizens (17%).

Figure 28: Spending on administration and security by states (2015-20)

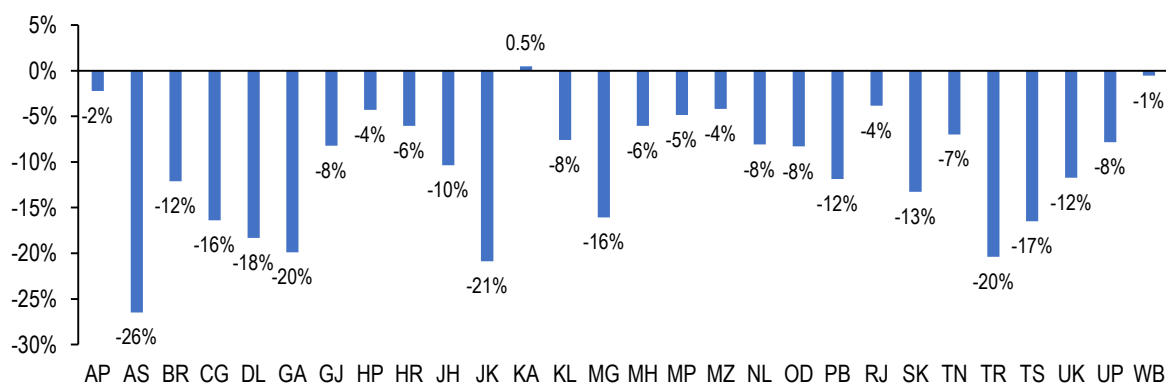


Sources: State Budget Documents; PRS.

States spent 8% less than what they budgeted during 2015-18

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 three years (2015-18) shows that on average, states underspend their budget by 8%. This underspending can be attributed to a shortfall in revenue collection of states. During this period, states made optimistic revenue projections and witnessed an average shortfall of 9% in their revenue collection (Figure 18). Such a scenario would have required states to undertake cuts in their spending and compensate for this shortfall in their receipts.

Figure 29: Underspending by states during 2015-18



Sources: State Budget Documents; PRS.

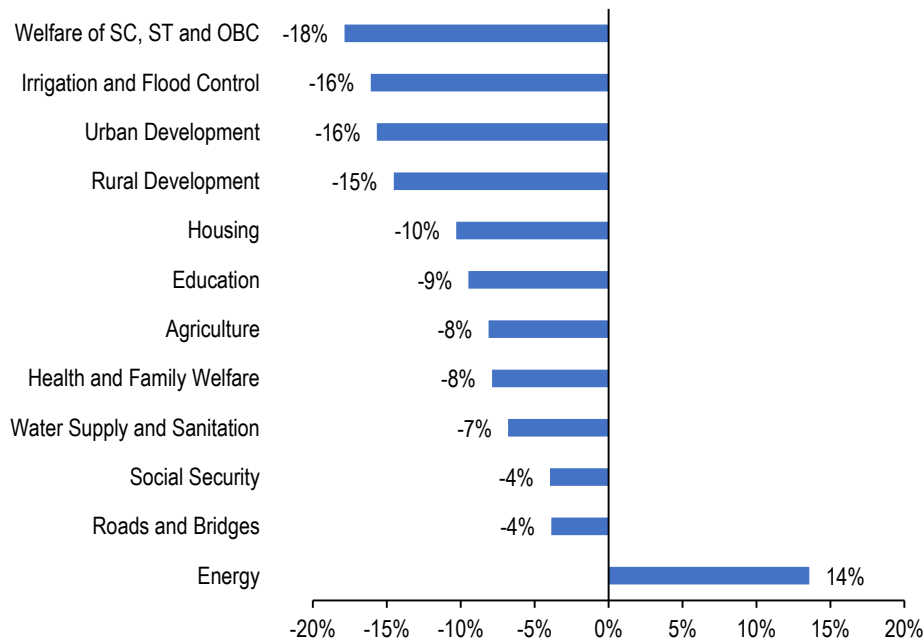
Note: Expenditure does not include debt repayment.

Average underspending on revenue expenditure during this period is 7%. However, the underspending on capital outlay is much higher at 14%. States such as Assam (26%), Jammu and Kashmir (21%), Tripura and Goa (20% each) see higher underspending as compared to others (Figure 29). During this period, states such as Karnataka, West Bengal and Andhra Pradesh have seen the least variance in the budget and actual figures.

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

Among major sectors on which state governments spend, welfare of SC, ST and OBC sector has witnessed the highest underspending (18%) during the 2015-18 period (Figure 30). This was followed by an underspending of 16% on irrigation and flood control and urban development. On the other hand, states under-budgeted their expenditure requirements on energy by 14%. Energy sector witnessed higher actual expenditure than budgeted due to the implementation of UDAY between 2015-2017 by certain states. Huge underspending could imply that states are being unable to meet their development targets in specific sectors.

Figure 30: Welfare of SC, ST and OBC witnessed the highest underspending; overspending on energy (2015-18)



Sources: State Budget Documents; PRS.

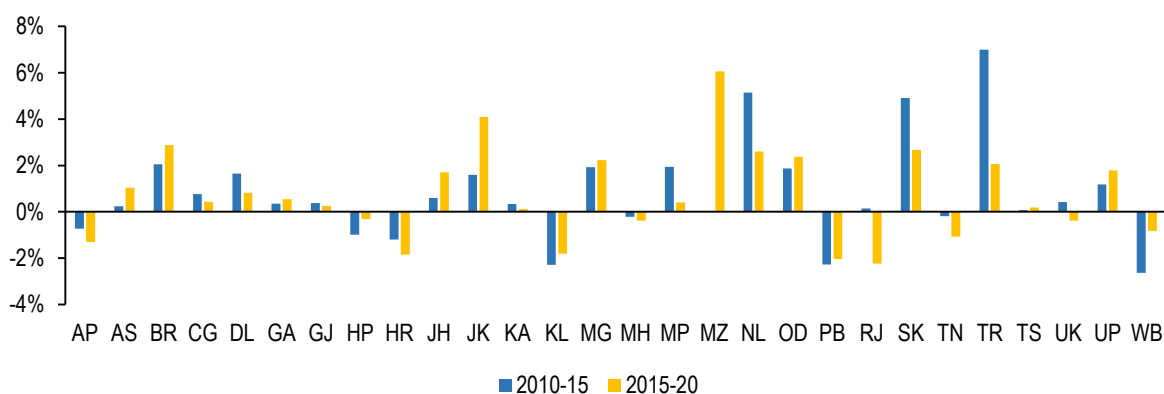
Eight states have had revenue deficit during 13th as well as 14th Finance Commission periods

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 salary and interest payments) over revenue receipts (such as taxes, devolution and grants from centre). A revenue deficit means that states need to borrow to meet expenses which do not create any assets. Conversely, a revenue surplus indicates that the revenue sources of states are sufficient to meet their revenue expenditure requirements in a given year. A revenue surplus can be used to incur capital outlay or pay off outstanding debt. While a high revenue surplus in the short term may allow for greater spending on asset creation, such a surplus for a longer-term may indicate inadequate revenue expenditure by the state.

Both 13th and 14th Finance Commissions (FC) recommended that a long term and permanent target for states should be to maintain a zero-revenue deficit. Kerala, Punjab and West Bengal were expected to eliminate revenue deficit by the end of 13th FC period (2014-15), and all other states were expected to eliminate their revenue deficit by 2011-12 or earlier. The 14th Finance Commission re-iterated this recommendation and expected the states to eliminate revenue deficit by 2019-20. It also provided for revenue deficit grants to some states.

Eight states have had a revenue deficit during both 13th and 14th FC periods (Figure 31). These include: (i) Andhra Pradesh, (ii) Himachal Pradesh, (iii) Haryana, (iv) Kerala, (v) Maharashtra, (vi) Punjab, (vii) Tamil Nadu, and (viii) West Bengal. Rajasthan and Uttarakhand were revenue surplus states during the 13th FC period but have registered revenue deficit during the 14th FC period. Mizoram had a marginal revenue deficit during the 13th FC period but has been able to eliminate deficit during 14th FC period.

Figure 31: Average revenue balance (as percentage of GSDP) during 13th and 14th FC periods



Note: Data of Telangana for the period 2010-15 is that of one year (2014-15). Data of Meghalaya for the period 2010-15 does not include data for 2010-11. Arunachal Pradesh is not shown in the figure as data is not available for all years. Sources: State Budget Documents: PRS.

During the 14th FC period, the revenue surplus is high in the case of some north-eastern states such as Sikkim and Mizoram, and hill states such as Jammu and Kashmir. This is mainly due to the large share of central transfers in their revenue receipts. The revenue surplus in other states can be attributed to augmentation of their own resources and reduction in expenditure by the state. Other notable states having high revenue surplus are Bihar (2.9% of GSDP) and Odisha (2.8% of GSDP).

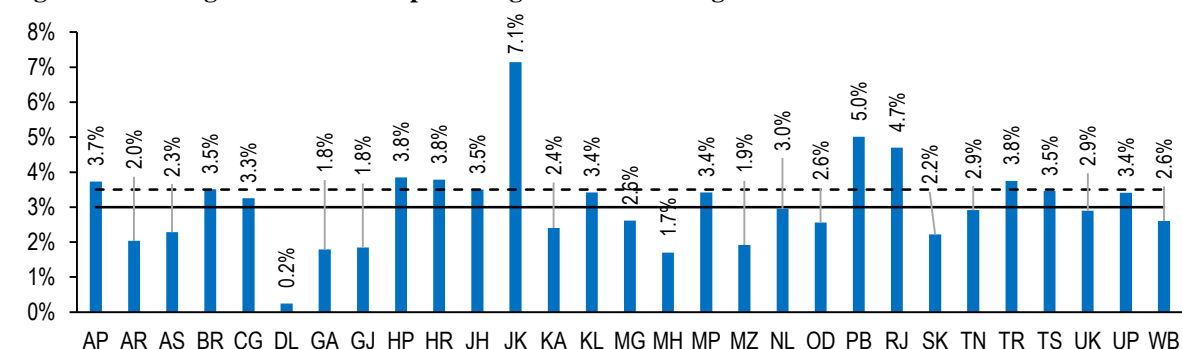
If the 15th Finance Commission, like previous Finance Commissions, recommends that states should eliminate revenue deficit, and if it does not specify revenue deficit grants, states with revenue deficit will be impacted. Elimination of revenue deficit grants would increase the borrowings requirement of these states. However, as borrowings are constrained by FRBM limits, capital outlay being financed out of these borrowings could get adversely affected. In 2019-20, six out of 21 revenue-surplus states have estimated revenue surplus to be within 0.25% of their GSDP. The expected decline in revenue collection due to economic slowdown poses a risk for these six states to end up with revenue deficit in 2019-20, and also causing the deficit to widen for the other states having revenue deficit.⁵

Average fiscal deficit of states at 2.9% of GSDP during 2015-20, 14 states over 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 outlay, 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.

During the 2015-20 period, 15 states have been able to maintain their average fiscal deficit within the 3% limit recommended by the 14th Finance Commission (Figure 32). Of the 14 states that have crossed the prescribed limit during this period, five states have contained their fiscal deficit within the conditional limit of 3.5%. States with fiscal deficit higher than 3.5% limit include Jammu and Kashmir (7.1%), Punjab (5.0%), and Rajasthan (4.7%).

Figure 32: Average fiscal deficit as percentage of GSDP during 2015-20

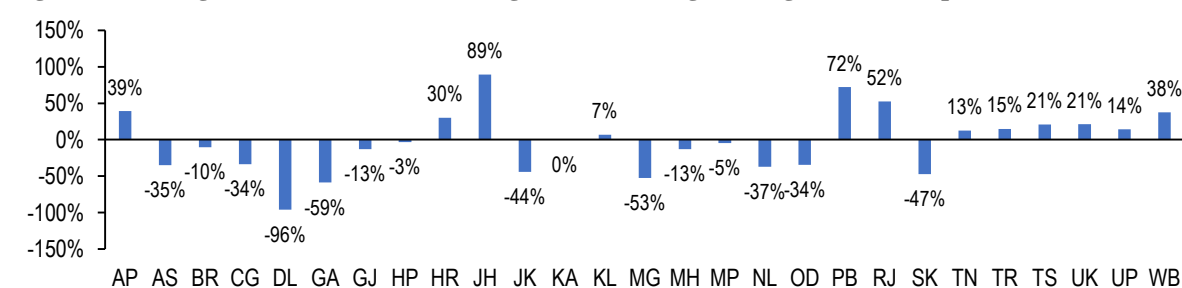


Note: Data of Arunachal Pradesh is that of three years (2017-20).

Sources: State Budget Documents; PRS.

Between 2015-16 and 2017-18, states on aggregate saw a 10% average increase in the fiscal deficit as compared to the estimates they had made during the budget (by 0.3% of GSDP). This indicates that some states end up borrowing more than what they estimate at the start of the year. During this period, the actual fiscal deficit of 12 states was greater than their budget estimates. For instance, the actual fiscal deficit of Jharkhand was on average 89% more than what they budgeted at the start of the year. Similarly, for Punjab and Rajasthan, the actual fiscal deficit was 72% and 52% more than the budget estimates, respectively. In 2019-20, 11 states have estimated to cross the 3% limit. Among these states, six states have estimated the fiscal deficit to be within 0.25% margin from the 3% limit. 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.

Figure 33: Change in fiscal deficit from budget to actual stage during the 2015-18 period



Sources: State Budget Documents; PRS.

Note that as per the Article 293 (3) of the Constitution, state governments require permission of the central government to raise any loan if there is still outstanding loan or guarantee that the central government has given to the state. The permission granted by the central government is based on projected GSDP figures. As the actual GSDP figures could be different, states may end up borrowing

above the budgeted fiscal deficit to GSDP ratio. In certain cases, the central government may give permission to raise borrowing beyond 3% limit (up to 3.5%) during the year. This may lead to higher actual fiscal deficit as compared to the budgeted fiscal deficit.

Financing of fiscal deficit

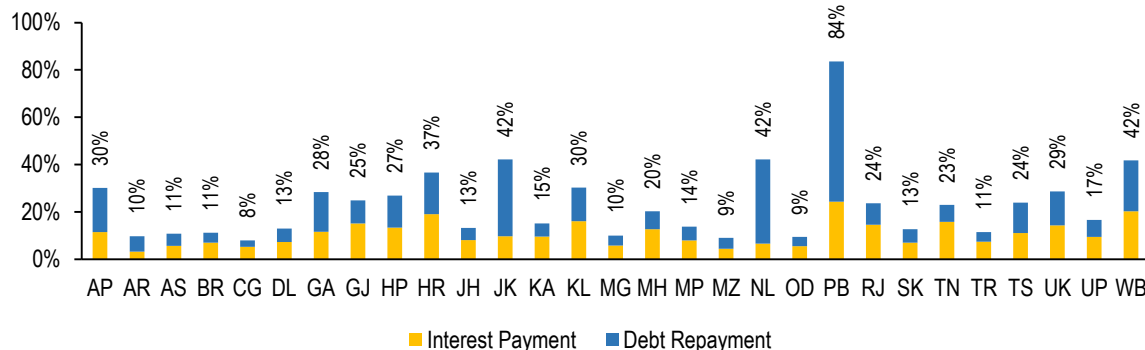
Major sources of financing of the fiscal deficit of the states are market borrowings, loans from financial institutions, and loans from the centre. States also incur liabilities in public account through various sources such as provident funds, reserve funds, and deposits. Market borrowings have increasingly become the major source of funds for financing fiscal deficit over the years. Share of market borrowings in gross fiscal deficit increased from an average of 48.5% during 2005-10 to 70.4% during 2015-18. Market borrowing financed 84% of the fiscal deficit in 2017-18. Most of the market borrowings come from domestic sources. In 2017-18, commercial banks (35.8%), insurance companies (34.1%), and provident funds (19.7%) were the major financiers of the market borrowings of the states.⁵

States spend 23% of their revenue receipts on debt servicing

Governments are required to service the debt by making periodic repayments of the principal amount along with the interest. Higher debt servicing costs constrain spending on other priorities. Between 2015-16 and 2019-20, the states have spent 23% of their revenue receipts on debt servicing. During this period, 52% of the amount was spent on interest payment, and 48% of the amount was spent on principal payment.

Among the 29 states, Punjab has used the highest proportion of its revenue receipts for debt servicing (84%) during the 2015-20 period. Jammu and Kashmir (42%), Nagaland (42%), and West Bengal (42%) are some other states which have been spending a higher proportion of their revenue receipts on debt servicing.

Figure 34: Debt servicing as a percentage of revenue receipts during the 2015-20 period



Sources: State Budget Documents; PRS.

RBI has observed that a less than 10% interest payments as a proportion of state's revenue receipts is indicative of debt sustainability of that state.⁵ In 2019-20, the states are estimated to spend 11.3% of their revenue receipts on interest payments. 14 out of the 29 states are estimated to spend more than 10% of their revenue receipts on interest payments. Punjab (23%), Haryana (20%), and West Bengal (19%) are some of the states which are estimated to spend a higher portion of their revenue receipts on interest payments in 2019-20.

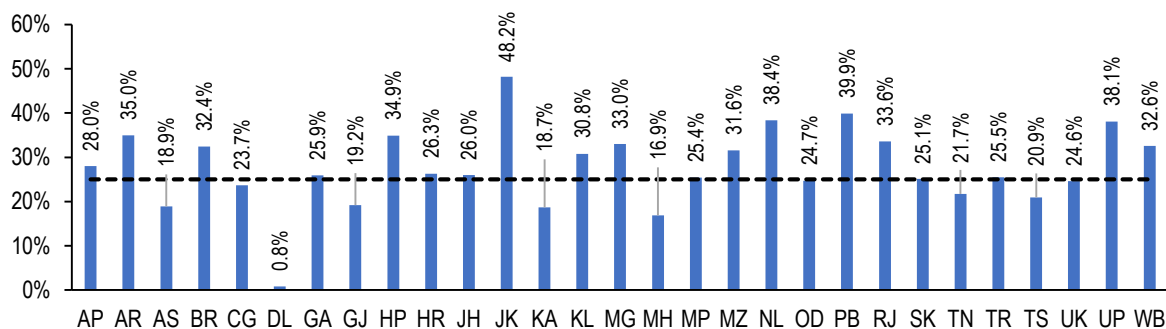
Liabilities of states estimated to be 24.6% of GSDP, 19 states cross the recommended limit

Outstanding liabilities refer to debt accumulated by states from the borrowings in the past. Higher outstanding liabilities may indicate a higher obligation for the state to repay loans in the coming years. The FRBM Acts of states usually specify limits on the outstanding liabilities as a percentage of GSDP. Typically, these limits are set at 25% of GSDP in a year.

At the end of 2019-20, the outstanding liabilities of states on aggregate is estimated to be 24.6% of their GSDP. 19 states are expected to cross the 25% limit at the end of 2019-20. States such as

Jammu and Kashmir (48.2%), Punjab (39.9%), and Nagaland (38.4%) have outstanding liabilities much higher than the average. Delhi has the lowest outstanding liabilities among all states (0.8% at the end of 2019-20). In 2017, FRBM review committee (Chair: Mr. N. K. Singh) had 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.¹¹ In 2019-20, 24 states have estimated their outstanding liabilities to be greater than 20% of GSDP.

Figure 35: Outstanding liabilities at the end of 2019-20 (in % of GSDP)



Sources: RBI State of State Finances 2019-20; PRS.

Cash balance of states

States have accumulated cash surplus, which has been invested in the short-term treasury bills of the central government. As the treasury bills yield a lower interest rate than the borrowing cost of states, states can benefit by using the cash surplus to repay their debt or borrow less the next year.^{5,12} Outstanding investments in these treasury bills at the end of 2017-18 was Rs 2.1 lakh crore (1.2% of GDP). In 2013-14, RBI had observed that this accumulation comes through: (i) revenue surplus of some states, (ii) borrowings in excess of requirements, (iii) funds earmarked for certain expenditure, (iv) funds transferred to government agencies but not utilised, and (v) unanticipated transfers from the centre.¹³

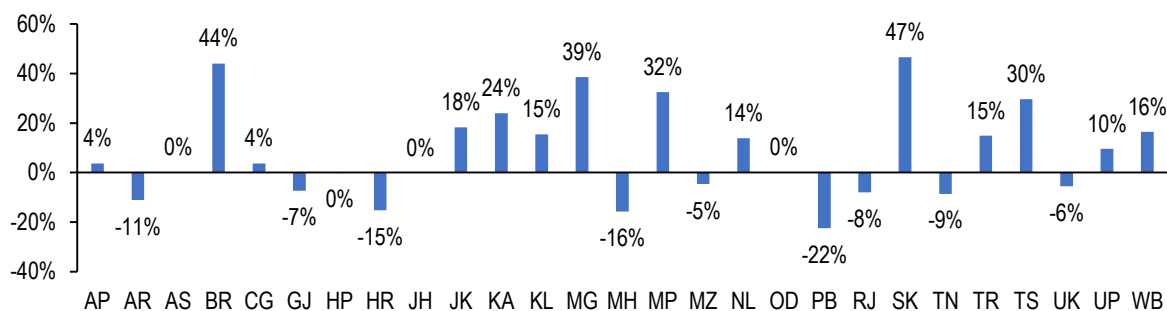
In 2015, the 14th Finance Commission noted that the holding of idle cash balances from borrowed funds increases the interest cost burden for state governments.¹³ It added that while states have to hold cash to manage the risks associated with shortfalls in revenues or to meet unforeseen expenditures, there is considerable scope for improvement in cash management by central as well as state governments.

Guarantees given by states increased by 0.5% of GSDP between 2016-17 and 2017-18

Outstanding liabilities of states does not include a few other liabilities that are contingent in nature, which states may have to honour in certain cases. State governments guarantee the borrowings of State Public Sector Enterprises (SPSEs) from financial institutions. 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. RBI has noted that these contingent liabilities are a risk to state governments owing to the large outstanding debt and losses of SPSEs. The guarantee given by the states was 2.6% of GSDP at the end of 2017-18. While the guarantee given by states declined from 3.7% of GSDP to 2.1% of GSDP between 2013-14 and 2016-17, it increased by 0.5% of GSDP between 2016-17 and 2017-18.

The change in outstanding guarantee level has seen large inter-state variances. For instance, during the 2013-18 period, states such as Sikkim (47%), Bihar (44%), and Meghalaya (39%) have seen a significant growth in the guarantee given by the state. At the same time, some states have seen a decline in government guarantee level. These include Punjab (22%), Maharashtra (16%), and Haryana (15%).

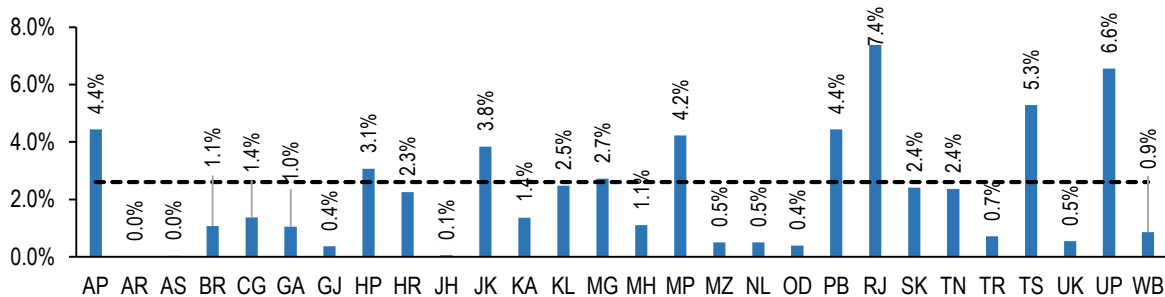
Figure 36: Annual average growth in outstanding guarantees during 2013-18



Note: Data not available for all years for Delhi and Goa. Data for Telangana is for the period 2014-18.
Sources: RBI State of State Finances 2019-20; PRS.

At the end of 2017-18, outstanding government guarantee of 12 states was less than 1% of their GDP (Figure 37). Some of the states with higher level of outstanding guarantee are Rajasthan (7.4%), Uttar Pradesh (6.6%), and Andhra Pradesh (4.4%).

Figure 37: Outstanding government guarantee as a percentage of GDP at the end of 2017-18



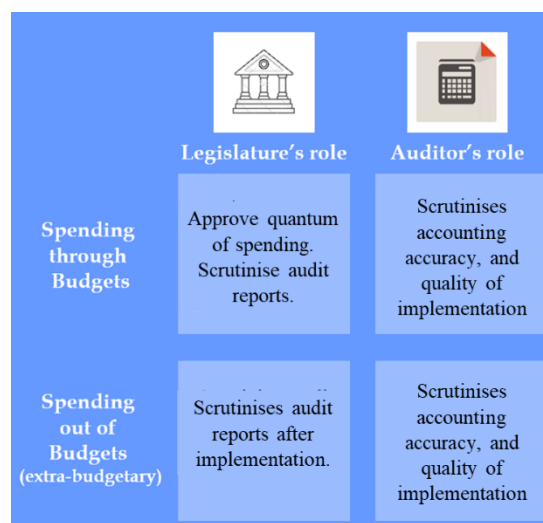
Note: The above chart does not include Delhi, as data is not available for 2017-18.
Sources: RBI State of State Finances 2019-20; PRS.

In 2019, RBI noted that although the guarantees given by states are at modest levels currently, state governments may not have enough fiscal space to bear the additional financial burden of invoked guarantees.⁵ Financing them via borrowings such as UDAY scheme may also have credit and financial market implications.⁵ For instance, debt takeover under the UDAY scheme added about Rs 2.1 lakh crore to outstanding debt of the states between 2015-16 and 2016-17.

Off-budget financing by states

Some states have been delivering several public services through specially incorporated entities (e.g., Kerala Infrastructure Investment Board, and Maha Infra). Through these entities, states are providing services such as drinking water, schools, hospitals, and housing for the poor.

In 2017, the FRBM Review Committee (Chair: Mr. N. K. Singh) observed that there is a growing trend of off-budget public spending by states.¹⁴ Such spending is financed from off-budget borrowings which state public sector undertakings (PSUs) or Special Purpose Vehicles (SPVs) undertake for expenditure on public services. Since this money is not directly borrowed by the government, it does not reflect in the budget, and thus does not get included in the state's debt and fiscal deficit. Off-budget mechanisms of borrowing allow the government to bypass legislative approval for expenditure as it remains outside budgetary control. However, as this spending is done by government bodies, it is still subject to CAG audits and further scrutiny by the legislatures' Committee on Public Undertakings.



Off-budget borrowings taken by PSUs and SPVs are given on the basis of the government's explicit or implicit guarantee and pose a fiscal risk.¹⁶ While there is an estimate of the explicit guarantees given by the government, implicit guarantees given for such off-budget borrowings remain beyond the scope of calculation. Note that all such guarantees, whether explicit or implicit, are contingent liabilities which states may have to honour if the government bodies default in their repayments. Debt takeover from discoms under UDAY (Rs 2.1 lakh crore) is one such example of contingent liability.

Extent of borrowing: The FRBM Review Committee (2017) noted that disclosure of off-budget borrowings remains unsatisfactory in most states. States do not collect or report information on public-private partnerships and other off-budget mechanisms in a comprehensive manner.¹⁴ Hence, the quantum of off-budget borrowing by states largely remains unknown. However, some information is available about off-budget borrowings through audit reports and estimates by Comptroller and Auditor General of India (CAG). In case of Karnataka, CAG observed that outstanding off-budget borrowings by the state was Rs 13,173 crore at the end of 2017-18, an increase of 29% over the previous year.¹⁵

Off-budget financing by the centre

In 2018, CAG reviewed the off-budget financing by the central government. It observed that off-budget financing was used by the central government for both revenue as well as capital expenditure.¹⁶ For instance, the central government provides subsidy to Food Corporation of India (FCI) for providing food grains under the Public Distribution System at subsidised prices. In recent years, when the budgetary allocation for subsidy bill has not been sufficient, FCI has been permitted to borrow from various sources such as loans from the National Small Savings Fund, unsecured short term loans, and bonds. In 2016-17, the liabilities of FCI on account of loans for subsidy arrears of previous years stood at Rs 81,303 crore. In another instance, the off-budget borrowings undertaken by the Indian Railway Finance Corporation (to finance railway projects) and the Power Finance Corporation (to finance power projects) amounted to Rs 3.05 lakh crore at the end of 2016-17.¹⁶

The CAG (2018) recommended that the central government should formulate a policy framework, which should include disclosure to Parliament, among other things. This disclosure should provide details of off-budget financing undertaken in the year by all organisations substantially owned by the government. Such details include: (i) rationale and objective of off-budget financing, (ii) quantum of such financing, (iii) budgetary support under the same programme or scheme, (iv) instruments and sources of financing, and (v) means and strategy for debt servicing.¹⁶

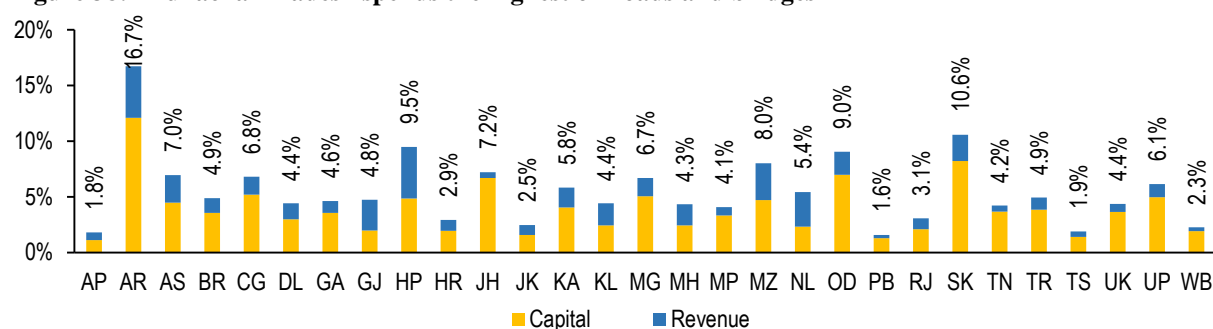
Annexure: Spending by states on key sectors

This section analyses expenditure by states on key sectors during the 2015-20 period. The share of expenditure on a particular sector denotes the share of that sector in the state's budget. Expenditure on a sector is the sum of the revenue expenditure made and the capital outlay done in that sector. Note that spending on a sector may be affected by funding from the centre in the form of grants for centrally sponsored schemes and other central grants. The sectoral spending in Delhi may be different from other states as Police is with the centre and the state has negligible rural or agricultural area.

Roads and bridges

During the 2015-20 period, states on an average have spent 4.6% of their budget on roads and bridges. This consists of 3.3% of the budget on capital outlay, and 1.3% of the budget on revenue expenditure.

Figure 38: Arunachal Pradesh spends the highest on roads and bridges

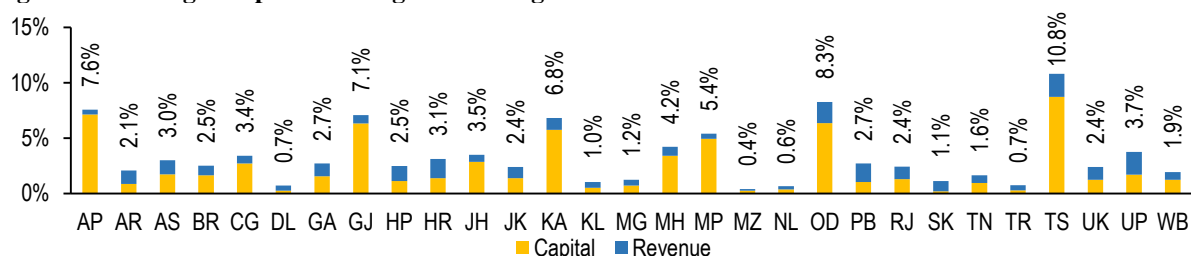


Sources: State Budget Documents; PRS.

Irrigation and flood control

During the 2015-20 period, states on an average have spent 4.1% of their budget on irrigation and flood control. This consists of 3.1% of the budget on capital outlay, and 1.0% of the budget on revenue expenditure.

Figure 39: Telangana spends the highest on irrigation and flood control

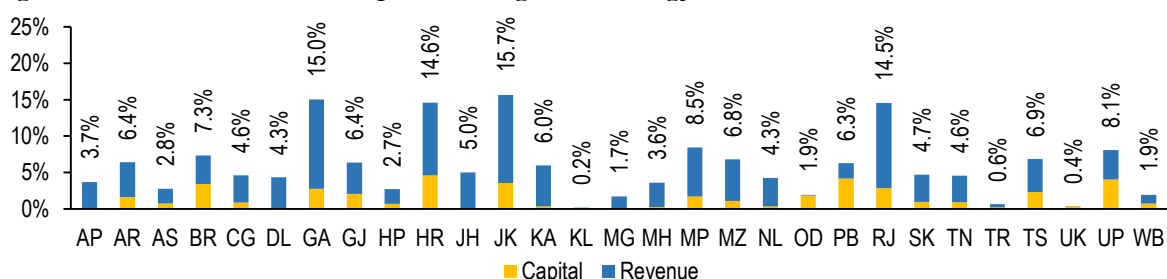


Sources: State Budget Documents; PRS.

Energy

Expenditure under this head includes subsidy to consumers, allocation for power projects, and assistance to discoms under UDAY scheme in certain states. During the 2015-20 period, states on an average have spent 6.2% of their budget on energy sector. This consists of 1.8% of the budget on capital outlay, and 4.4% of the budget on revenue expenditure.

Figure 40: Jammu and Kashmir spends the highest on energy

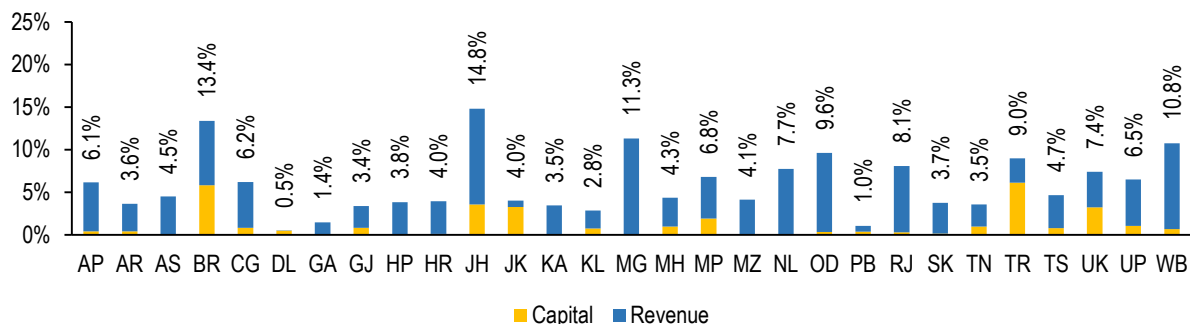


Sources: State Budget Documents; PRS.

Rural Development

Expenditure on this sector includes implementation of various rural development schemes, such as the National Rural Employment Guarantee Scheme, and the Swachh Bharat Mission. During the 2015-20 period, states on an average have spent 6% of their budget on rural development. This consists of 1.1% of the budget on capital outlay, and 4.9% of the budget on revenue expenditure.

Figure 41: Jharkhand and Bihar spend the highest on rural development

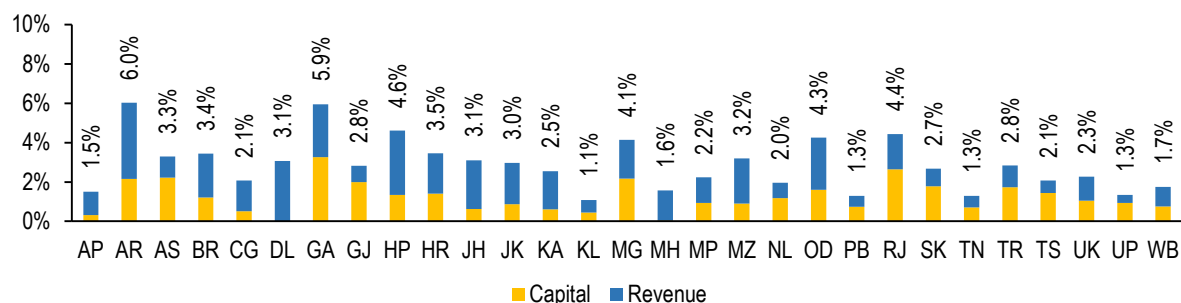


Sources: State Budget Documents; PRS.

Water supply and sanitation

During the 2015-20 period, states on an average have spent 2.3% of their budget on water supply and sanitation. This consists of 1% of the budget on capital outlay, and 1.3% of the budget on revenue expenditure.

Figure 42: Arunachal Pradesh spends the highest on water supply and sanitation

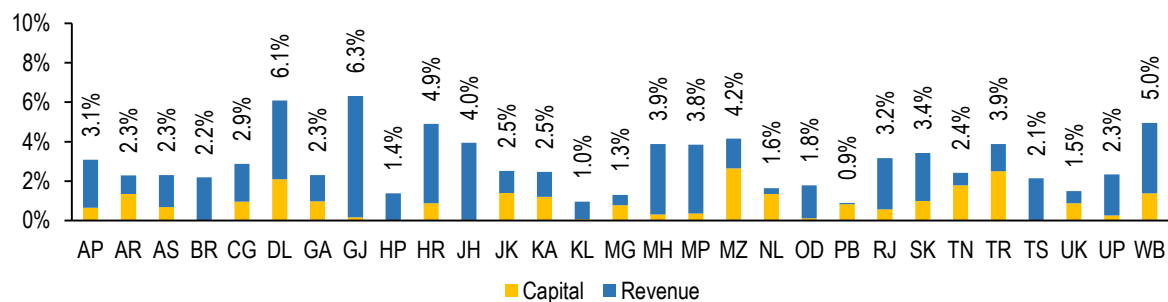


Sources: State Budget Documents; PRS.

Urban Development

During the 2015-20 period, states on an average have spent 3.1% of their budget on urban development. This consists of 0.6% of the budget on capital outlay, and 2.4% of the budget on revenue expenditure.

Figure 43: Gujarat spends the highest on urban development

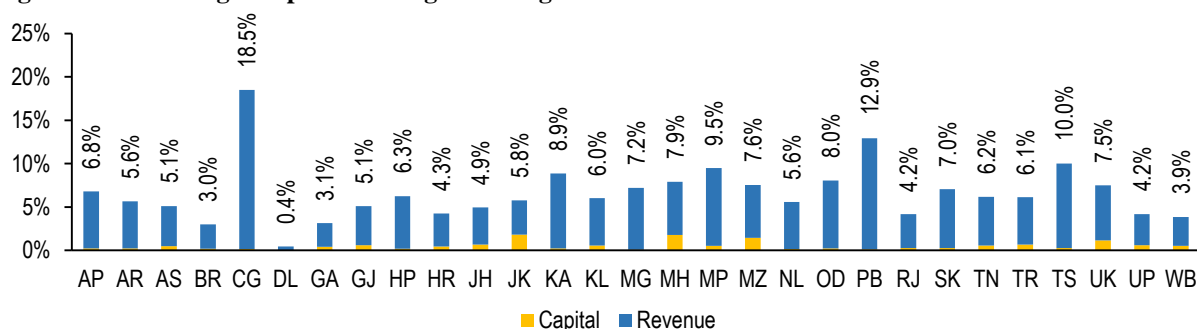


Sources: State Budget Documents; PRS.

Agriculture and allied activities

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. During the 2015-20 period, states on an average have spent 6.5% of their budget on agriculture. This consists of 0.6% of the budget on capital outlay, and 5.9% of the budget on revenue expenditure.

Figure 44: Chhattisgarh spends the highest on agriculture and allied activities

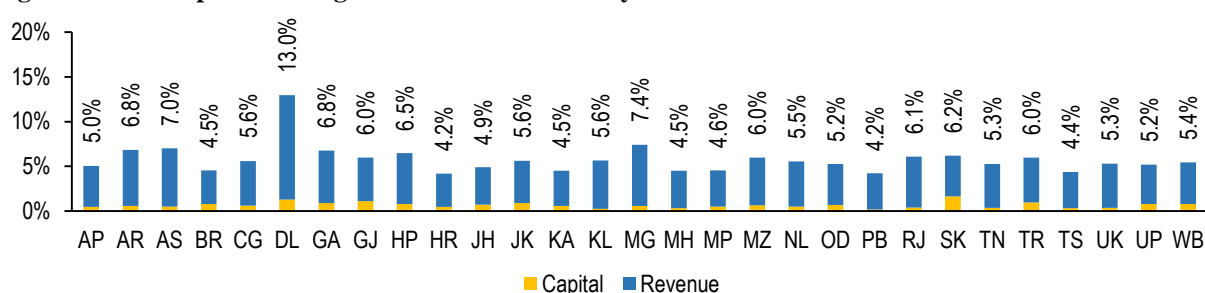


Sources: State Budget Documents; PRS.

Health and family welfare

During the 2015-20 period, states on an average have spent 5.3% of their budget on health and family welfare. This consists of 0.6% of the budget on capital outlay, and 4.7% of the budget on revenue expenditure. 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.

Figure 45: Delhi spends the highest on health and family welfare

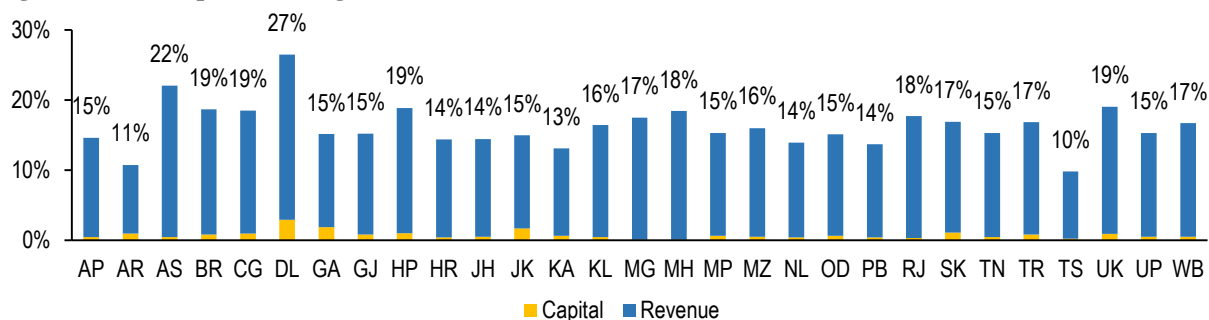


Sources: State Budget Documents; PRS.

Education

During the 2015-20 period, states on an average have spent 16% of their budget on education sector. This consists of 0.5% of the budget on capital outlay, and 15.5% of the budget on revenue expenditure. 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.

Figure 46: Delhi spends the highest on education

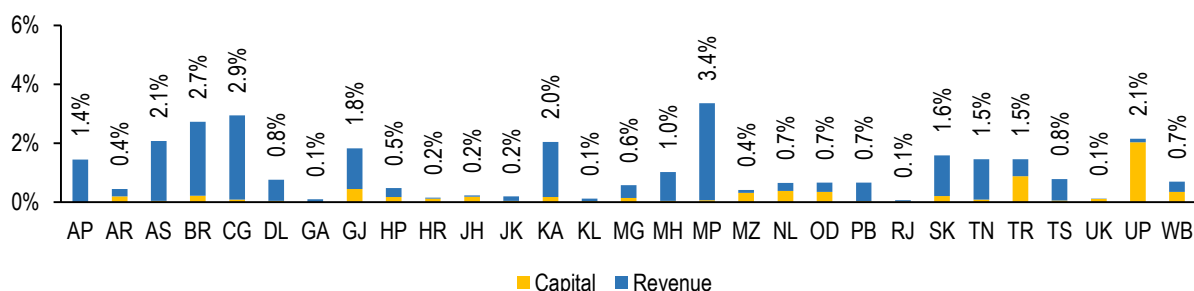


Sources: State Budget Documents; PRS.

Housing

During the 2015-20 period, states on an average have spent 1.4% of the budget on the housing sector. This consists of 0.4% of the budget on capital outlay, and 1% of the budget on revenue expenditure.

Figure 47: Madhya Pradesh spends the highest on housing

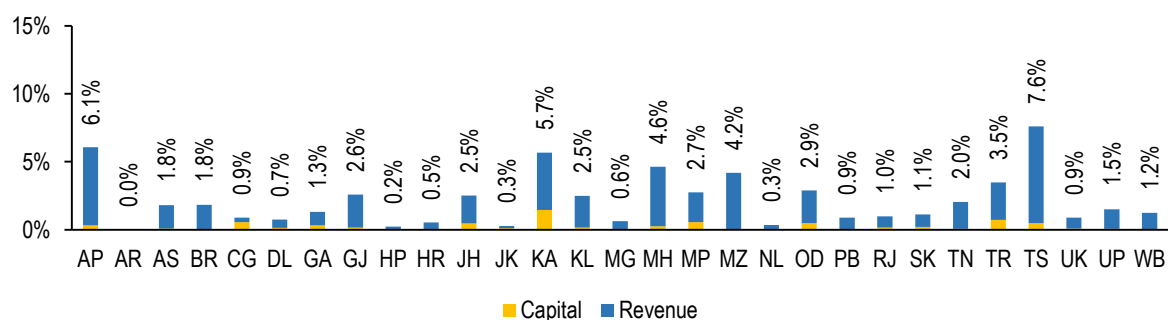


Sources: State Budget Documents; PRS.

Welfare of SC, ST and OBC

During the 2015-20 period, states on an average have spent 2.7% of the budget on welfare of SC, ST and OBC. This consists of 0.4% of the budget on capital outlay, and 2.3% of the budget on revenue expenditure.

Figure 48: Telangana spends the highest on welfare of SC, ST and OBC

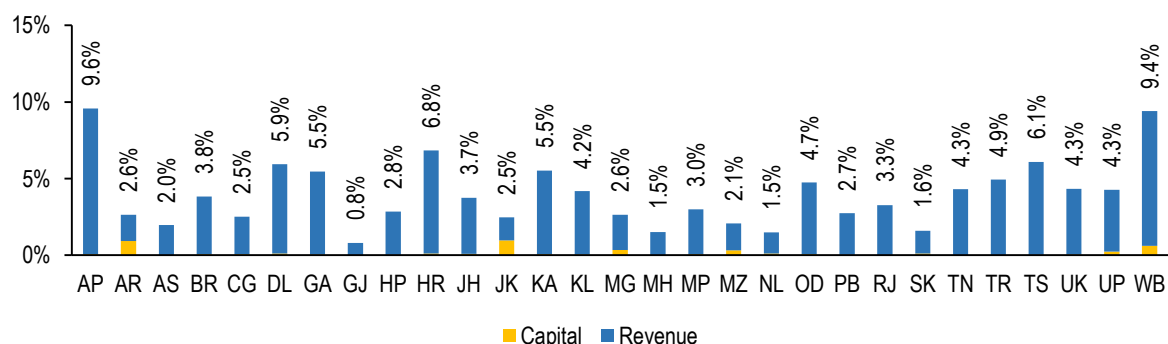


Sources: State Budget Documents; PRS.

Social Security

During the 2015-20 period, states on an average have spent 4.3% of the budget on social security. This consists of 0.2% of the budget on capital outlay, and 4.1% of the budget on revenue expenditure.

Figure 49: Andhra Pradesh spends the highest on social security

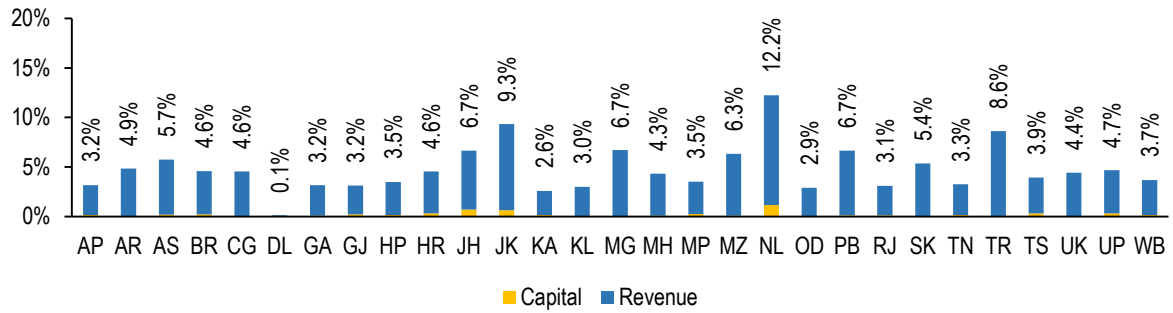


Sources: State Budget Documents; PRS.

Police

During the 2015-20 period, states on an average have spent 4.1% of the budget on police. This consists of 0.2% of the budget on capital outlay, and 3.9% of the budget on revenue expenditure.

Figure 50: Nagaland spends the highest on police



Sources: State Budget Documents; PRS.

Glossary of key terms

Receipts indicate the money received by the government. This includes: (i) the money earned by the government, (ii) grants received (mainly from the centre), and (iii) the money it receives in the form of borrowings or repayment of loans.

Capital receipts indicate the receipts which lead to a decrease in assets or an increase in liabilities of the government. It consists of: (i) the money earned by selling assets such as shares of public enterprises, and (ii) the money received in the form of borrowings or repayment of loans.

Revenue receipts are receipts which do not have a direct impact on the assets and liabilities of the government. This consists of the money earned by the government through tax and non-tax sources (such as dividend income and grants from the central government).

Capital expenditure is used to create assets or to reduce liabilities. It consists of: (i) the money spent by the government on creating assets such as roads and hospitals, and (ii) the money given by the government in for repayment of its borrowings.

Revenue expenditure is the expenditure by the government which does not impact its assets or liabilities. For example, this includes salaries, interest payments, pension, administrative expenses, and subsidies.

Devolution of union taxes means the money received by states from the central government as the state's share in union taxes such as corporation tax, income tax, central GST, customs, and union excise. It is devolved to the state as per the criteria recommended by the Finance Commission.

Grants-in-aid are transferred by the central government to states and are tied in nature, i.e., they are linked to specific schemes and expenditure avenues, such as Swachh Bharat Mission, and National Health Mission.

Outstanding debt is the stock of money borrowed by subsequent governments over the years which the government currently owes. The figure for a financial year indicates the government's outstanding debt at the end of the year.

Fiscal deficit is the gap between the government's expenditure requirements and its receipts. This equals the money the government needs to borrow during the year. A surplus arises if receipts are more than expenditure.

Revenue deficit is the gap between the revenue components of receipts and expenditure, i.e., revenue disbursements and revenue receipts. This indicates the money the government needs to borrow to spend on non-capital components (which do not lead to creation of assets).

Primary deficit equals fiscal deficit minus interest payments. This indicates the gap between the government's expenditure requirements and its receipts, not taking into the account the expenditure incurred on interest payments on loans taken during the previous years.

Consolidated Fund of the State is the Fund or account into which all of the state government's receipts are credited, and which it uses for financing its expenditure.

Charged expenditure includes expenditure which is not required to be voted on by the Assembly and is charged directly from the Consolidated Fund of the State. Such expenditure can still be discussed in the Assembly. Examples include interest payments, and salaries and allowances of the Governor and judges of the High Court.

Voted expenditure consists of all expenditure other than charged expenditure. Such expenditure is required to be voted upon by the Assembly in the form of Demands for Grants.

Fiscal Responsibility and Budget Management Framework relates to laws passed by states for institutionalizing financial discipline. The framework provides targets for revenue deficit, fiscal deficit, and outstanding debt to be met for a specified timeframe by states. It also requires states to bring out statements on fiscal policy for greater transparency.

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- ¹ Monthly Data on the Union Government Accounts for the month of October 2019, Controller General of Accounts, Ministry of Finance, as accessed on December 24, 2019, <http://www.cga.nic.in/MonthlyReport/Published/10/2019-2020.aspx>.
- ² Provisional Accounts of Union Government for 2018-19, Controller General of Accounts, Ministry of Finance, <http://www.cga.nic.in/MonthlyReport/Published/3/2018-2019.aspx>.
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- ⁶ 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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- ¹⁴ FRBM Review Committee Report, Volume-I, January 2017, <https://dea.gov.in/sites/default/files/Volume%201%20FRBM%20Review%20Committee%20Report.pdf>.
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- ¹⁶ Compliance of the Fiscal Responsibility and Budget Management Act by the central government, Report No 20 of 2018, Comptroller and Auditor General of India, https://cag.gov.in/sites/default/files/audit_report_files/Report_No_20_of_2018_Compliance_of_the_Fiscal_Responsibility_and_Budget_Management_Act_2003_Department_of_Economic_Affairs_Minis.pdf.

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