25 April 2022

STCI Primary Dealer Ltd

State Finances – A Report

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The Fifteenth Finance commission (FC-XV) report for 2021-26 was published as "Finance commission in COVID times" acknowledging the stress of the pandemic on economic policy. The lockdown affected the demand-supply dynamics for the economy during FY2020-21 and FY2021-22. At the national level, India's GDP contracted annually by a significant 6.6% for FY2020-21. Headline retail inflation remained above the RBI's upper tolerance level of 6% for a substantial time period of the first financial year of the pandemic, and averaged at 6.2% largely due to supply side disruptions.

On a sub-national level States were similarly affected. In conformity to the principle of "Co-operative Federalism" the Central government had implemented performance incentive linked measures. These reforms included financial support to the States in the form of untied as well as performance-based funds. It was obvious that the Gross state domestic product (GSDP) would be adversely affected and so would the revenue streams of States with varying intensity depending on the geography and nature of the state's output. Large variations in the revised estimates as compared to the budget estimates can be seen during this period, since most of the States had presented their respective budgets before the onset of the pandemic, during FY2020-21. The fiscal impact of the pandemic can be seen in the fiscal deficit which was 4.7% in the revised estimates as compared to a 3.2% set in the budget estimates and a significant 170 basis points higher than 3% as prescribed by the Fiscal Responsibility Legislation (FRL).

Recognizing that there will be a significant spillover effect of the pandemic on state finances the central government has had allowed the States to augment their borrowings in FY2020-21, with emphasis on efficient usage of untied funds and conditional borrowings, depending on the States fulfilling certain performance-based criteria like the amount of capital spending done by them. So, a total limit of 3.5% of GSDP was sanctioned for FY2020-21, an additional 0.5% was earmarked for incentivizing capital spending. While fiscal rules set for the State governments have been relaxed for the two years, and the fiscal roadmap for the next 5 years has been revised by the FC-XV, the current stresses on state finances need to be analyzed in that context. The fiscal roadmap as given by the FC-XV is given below

Table 1: Fiscal Consolidation Glide Path

Item (Per cent of GDP)	2021-22	2022-23	2023-24	2024-25	2025-26
Revised Limit proposed by FC-XV	4.0	3.5	3.0	3.0	3.0
Incentive Based Extra Borrowing	0.5	0.5	0.5	0.5	
Upper net borrowing limit	4.5	4.0	3.5	3.5	3.0
Lower Net borrowing limit	3.0	3.0	3.0	3.0	3.0

Source: State Finances – A Study of Budgets 2021-22

State Revenues: Revenue receipts constitute a significant 75% of the total receipts of the States. The estimates for revenue growth in FY2021-22 are robust at 24% as a speedy recovery from the woes of the COVID-19 pandemic is assumed. A major pick-up in the States Own Tax Revenues (SOTR) is estimated with a growth of 30% over the revised estimates of the previous year. States Own Tax Revenues comprise 45% of the revenue receipts. SOTR comprises of three segments i.e.

1. Income tax
2. Taxes on Property and Capital
3. Taxes and Commodities and Services (This includes SGST)

The estimates for FY2021-22 project SOTR growth at 30%, making it the driving factor behind the growth in overall revenue receipts. The estimates for other sources of revenue like the States Own Non-Tax Revenue (SONTR) growth at 36% and growth in Central transfers at 18% also accounts, in part, for the substantial rise in States' revenue receipts for FY2021-22.

Table 2: Revenue Receipts (In Rs. Lakh Crore)

	Composition			As a per cent of Revenue Receipts		
	2019-20	**2020-21 (RE)**	**2021-22 (BE)**	**2019-20**	**2020-21 (RE)**	**2021-22 (BE)**
Revenue Receipts (1+2)	**26.70**	**27.91**	**34.55**	**100**	**100**	**100**
(1) States Own Revenues (a+b)	14.85	14.53	18.81	56	52	54
(a) States Own Tax (SOTR)	12.24	12.41	15.95	46	44	46
(b) States' Own Non-Tax (SONTR)	2.61	2.11	2.87	10	8	8
(2) Central Transfers (c+d)	11.85	13.38	15.73	44	48	46
(c) Shareable Taxes	6.51	5.9	6.9	24	21	20
(d)Grants-in Aid	5.35	7.48	8.83	20	27	26

Source: RBI

The increase in the States Own revenue reveals self-reliance in fiscal resources and hence less dependence on the Centre's fiscal resources. The composition of the SOTR for various States is given below, separately for the general as well as the North Eastern and Himalayan States (NE&H). NE&H States receive additional help from the Centre in terms of grants due to their special geographical location and consequent economic hardships. The States own revenue which sums up Tax (SGST + Non SGST) and Non-Tax revenue indicates the economic strength of the State to rely less on grants and more on its own capability to raise revenue and incur expenditure according to its own specific economic and social needs.

Chart 1:Own Revenue as a per cent of Revenue Receipts-General States

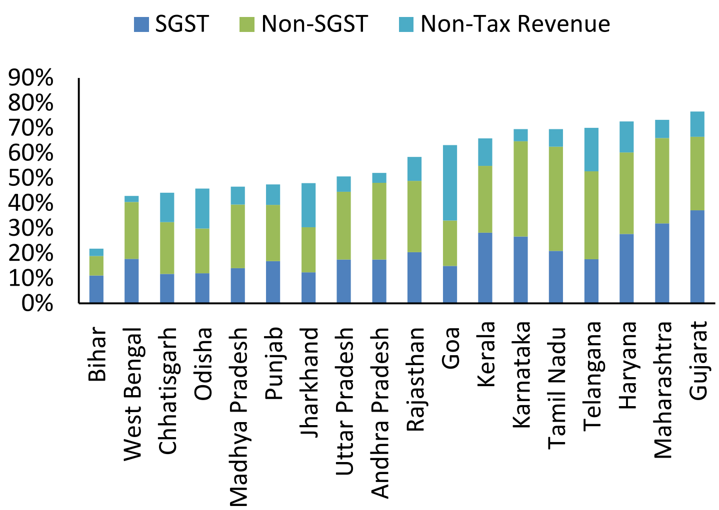
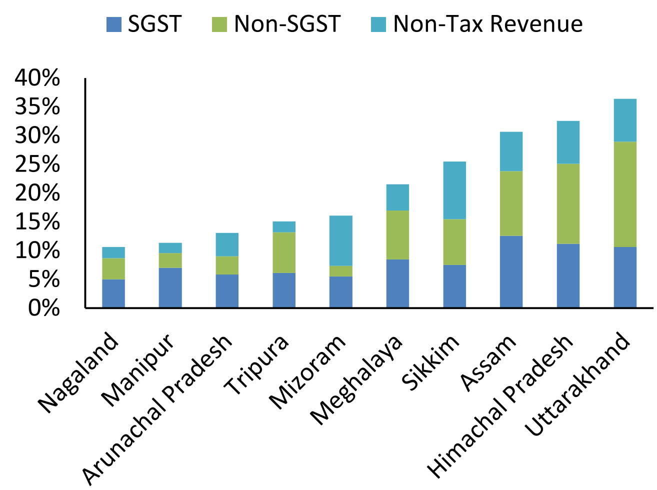


Chart 2-Own Revenue as a per cent of Revenue Receipts- NE&H



Source: State Finances – A Study of Budgets 2021-22

The charts above are indicating a ratio of the States' own revenue (tax +non-tax) as a percent of revenue receipts. We observe that States which have a dominance of industry in their economy have a robust share of SGST as a part of overall revenue receipts. The States of Maharashtra (SGST of 32%), Gujarat (SGST of 37%) have a robust SGST collection, whereas States such as Bihar (SGST of 11%), Chhattisgarh (SGST 12%) have a tepid GST collection. A similar pattern can be observed in the North Eastern & Himalayan States, with the highest SGST collection seen in Assam at 13%, and only two other States of Himachal Pradesh and Uttarakhand seeing GST collections in double digits as a percent of revenue receipts, rest of the north eastern States have SGST collections in single digits as a part of overall revenue receipts. On an aggregate basis, the explanation for the dependency of the NE&H States can be found in the statistics, as the average percentage share of States own revenue is 57% for general States as compared to 22% for the NE&H States.

As a mirror image of the above charts (Chart 1 & 2), the share of current transfers from the Center to the States provides a picture from the view point of the dependency of the various States on the pool of Central resources. The resources the Center has to expend on States like Bihar and the other NE& H States are far higher than others.

Chart 3: Current Transfers as a per cent of Revenue Receipts

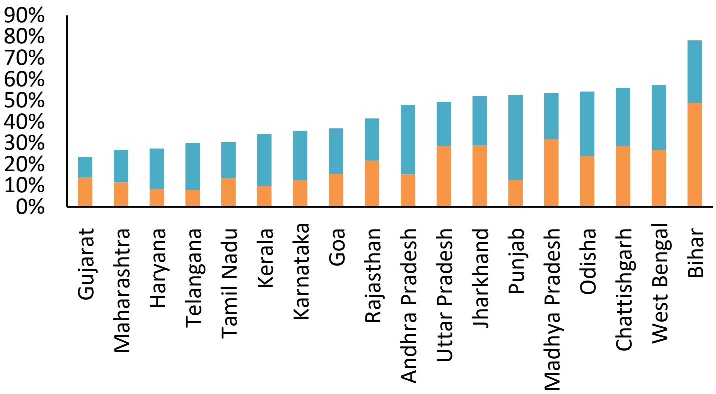
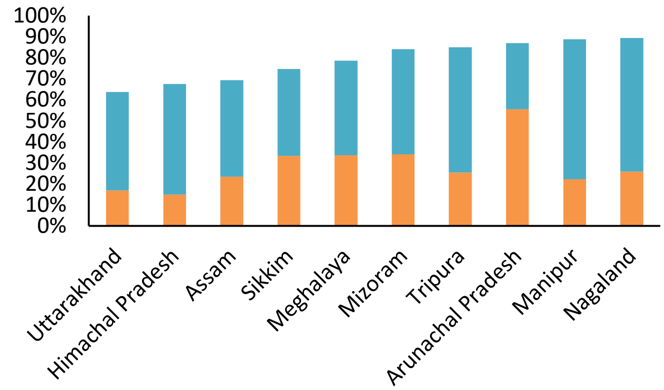


Chart 4 : Current Transfers as a per cent of Revenue Receipts



Source: State Finances – A Study of Budgets 2021-22

Current transfers to revenue receipts ratio for Bihar is 78%, which is significantly higher than the national average of 44%. Some of the general States like West Bengal (57%), Chhattisgarh (56%), Odisha (54%), Madhya Pradesh (53%), Jharkhand (53%) and Uttar Pradesh (48%) have higher than average dependency on Central transfers. The dependency of the NE & H States on average is at a significant 79%, within which States like Assam (69%), Uttarakhand (64%), and Himachal Pradesh (67%) can garner a moderate amount of resources through economic activity. States in the far north east are almost completely dependent on Centre's help with the States of Manipur (89%), Nagaland (89%) almost completely dependent on the transfers from the Centre. Decomposing this data further, for general States the national average of 44% is bifurcated into an average share of 20% in central taxes and 24% share of grants from Centre. Similarly, for NE&H States the ratios are 29% and 50% for share in Central taxes and grants from Centre respectively.

Table 3: Revenue Receipts of State Governments as a per cent of GSDP

	Own Revenues			**Current Transfers**			
	OTR	**ONTR**	**Own Revenue**	**Share in Central Taxes**	**Grants from Centre**	**Current Transfers**	**Revenue Receipts**
	1	**2**	**3=1+2**	**4**	**5**	**6=4+5**	
2017-18	6.6	1.1	7.7	3.5	2.4	5.9	13.6
2018-19	6.4	1.2	7.6	4.0	2.3	6.3	13.9
2019-20	6.0	1.3	7.3	3.2	2.6	5.8	13.1
2020-21	6.3	1.1	7.4	3.0	3.8	6.8	14.1
2021-22	7.2	1.3	8.5	3.1	4.0	7.1	15.5

Source: RBI

Data for the years beginning in FY2017-18, indicates a dip in the States' own revenues as well as current transfers from the States in FY2019-20, due to an economic slowdown. This had preceded the pandemic, and in reality, during the first year of the COVID-19 pandemic the States own revenue improved marginally as States own tax revenues increased on higher sales tax/VAT on petrol and diesel and overall revenue receipts also increased due to increase in grants from the Centre allocated as a response to the crisis. Based on the estimated OTR to GDP ratio for FY22, the average ratio for general States is 6.7%. Amongst the general category States, Uttar Pradesh has the highest ratio at 9.8%, followed by Kerala, Maharashtra and Telangana at 8.2%, Andhra Pradesh at 8.0%, Rajasthan at 7.5%, Punjab at 7.1% and other twelve States equal to or below the average ratio. For the special category States, the average OTR to GDP ratio for FY22 is projected at 5.0% with Arunachal Pradesh with the highest ratio at 7.2%.

States Expenditures: The fiscal discipline maintained by the States was compromised during the pandemic years. Barring the financial years of FY2009-10 (post Global Financial Crisis), and the two consecutive years of 2015-16 and 2016-17 of the Ujjwal Discom Assurance Yojana (UDAY), States had managed to bring their combined Gross Fiscal Deficit (GFD) below the prescribed threshold of 3%. The FY2020-21 the Fiscal Responsibility Legislation (FRL) limit was increased to 4% from the 3% earlier, in anticipation of the breach that was unfolding even as the FC-XV was writing the report. Large variations between the budget estimates and revised estimates were caused by the pandemic. The series of lockdowns clamped the State tax and Non-Tax revenues and the States started curbing their expenditures to maintain the FRL targets. Development expenditures on the core issues was curbed as a result of the dwindling revenues. Capital Expenditure (CAPEX) curbed on social and economic services.

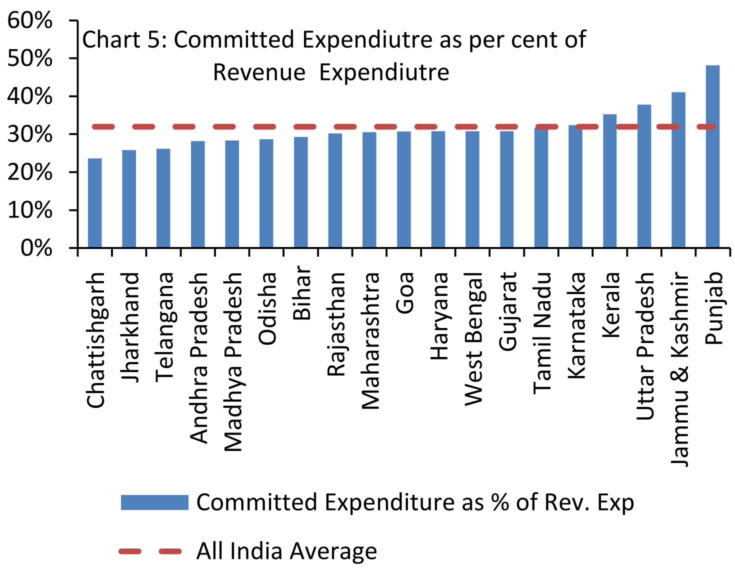
Table 4: Expenditure of States (In Rs Lakh Crore)

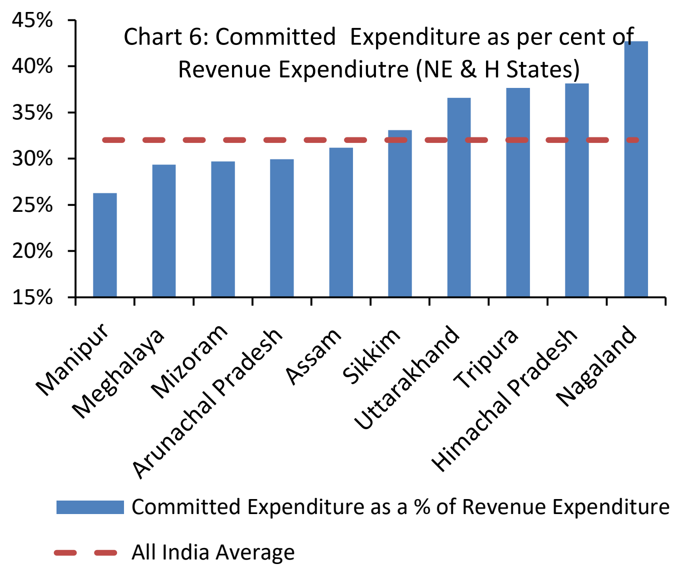
	Composition			**As a per cent of Aggregate Expenditure**		
	2019-20	**2020-21(RE)**	**2021-22 (BE)**	**2019-20**	**2020-21(RE)**	**2021-22 (BE)**
Aggregate Expenditure	**32.52**	**37.4**	**42.95**	**100**	**100**	**100**
(1+2)=(3+4+5)						
1. Revenue Expenditure	27.920	31.86	35.72	86%	85%	83%
2. Capital Expenditure	4.600	5.54	7.23	14%	15%	17%
3. Development Expenditure	21.63	25.27	29.11	67%	68%	68%
4. Non-Development Expenditure	10.05	11.22	12.88	31%	30%	30%
5.Others	0.83	0.91	0.96	3%	2%	2%

Source: RBI

Recent Trends: The aggregate expenditure of States has increased significantly by 15% since the pandemic struck in early FY2020-21. The quality of expenditure has improved with the State governments budgeting for a sharp increase in capital expenditures. This would align with the Central government incentivizing the States with a leeway to borrow 0.5% of GSDP as result of incurring more capital expenditure. So, the budgeted levels of revenue expenditure are at 83% of total spending as compared to 85% in the previous financial year and capital expenditure stands at 17% as compared to the 15% earlier. This change of spending pattern is welcome development if is adhered to by the States. In theory, increased Capital spending would lead to a push in output due to better multiplier effects of the spending. In practice though, since Capital spending is discretionary, it is customary to budget an increase and revise it lower if State revenues take a hit or there is unforeseen increase in Revenue expenditure.

Committed expenditure comprises of three components, interest payments, pensions, and administrative expenses. These form a major portion of the Revenue expenditure and the national average for the committed expenditure is around 32%. Within general States, the States of Karnataka, Kerala, Uttar Pradesh, and Punjab are States which have a share of committed expenditure to Revenue expenditure higher than the national average. In the NE&H States Sikkim, Uttarakhand, Tripura, Himachal Pradesh and Nagaland are above the national average.





Source: State Finances – A Study of Budgets 2021-22

A higher share of committed expenditure creates a drag for economic growth. Given the budget constraints of any State, a higher share of committed expenditure also means lower room for Capital spending and dimer economic prospects.

The practice of over budgeting is also prevalent in some States. Punjab had budgeted a 113% increment in its expenses for FY2021-22 on the ‘Others’ segment within administrative services, over the revised estimates of FY2020-21. Notably, the state spends less than a lakh crore in these services, but over budgets them to an extreme level. This pattern can also be observed in its previous year’s statement. For example, the state had budgeted an expense amount of Rs.5 Lakh Crore during FY2020-21 but the revised estimates indicate a total spending of Rs. 95,361 crore only. This would indicate that for some States the numbers in the budget estimates are grossly overestimated and in reality, the state will spend approximately ~10% of the budgeted amount.

Table 5 : Expenditure Pattern of State Governments as a per cent of GSDP				
Year	**Revenue Expenditure**	***of which* interest payments**	**Capital Expenditure**	**Aggregate Expenditure**
	1	2	3	4=1+3
2017-18	13.7	1.7	2.5	16.2
2018-19	14	1.7	2.6	16.5
2019-20	13.7	1.7	2.3	16
2020-21	16.1	2	2.8	18.9
2021-22	16	2	3.2	19.3

Source: RBI

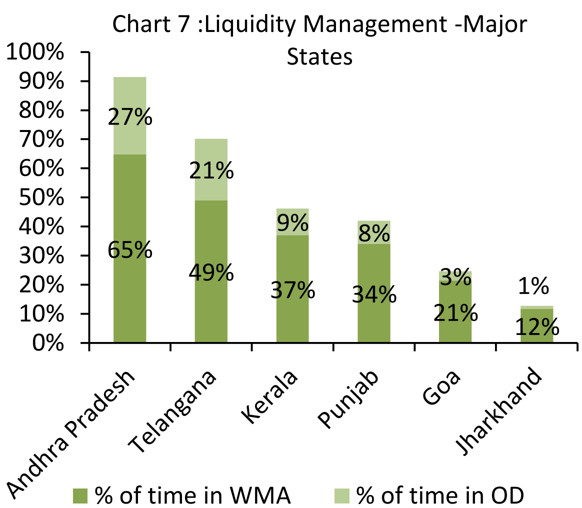
Revenue expenditure as a percentage of GDP is estimated to be marginally lower than the revised estimates of FY2020-21, while aggregate expenditure has increased by ~300 basis points largely due to a similar increase in both Revenue and Capital expenditure. FY2021-22 will be similar in trend for Capital expenditure which would increase by 40 basis points and Revenue expenditure decline by 10 basis points during the year.

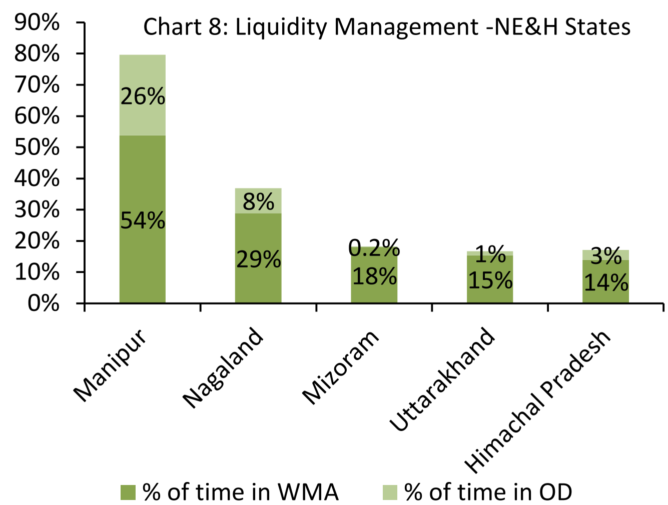
Deficit Indicators:

Table 6 : Major Deficit Indicators of State Governments (Amt in Rs. Lakh Crore)				
	2019-20 (Actual)	**2020-21 BE**	**2020-21 RE**	**2021-22 BE**
Gross Fiscal Deficit	5.25	6.22	9.32	8.20
as a % of GSDP	2.6	3.2	4.7	3.7
Revenue Deficit	1.21	-0.04	3.95	1.18
as a % of GSDP	0.6	0	2	0.5
Source: RBI Report on State Finances 2021-22: Negative sign indicates surplus				

Revised estimates of the Fiscal deficit for FY2020-21 reflect in good measure the economic impact of the pandemic. The fiscal deficit was revised by a significant 78% as compared to the actuals of FY2019-20, and by 50% when compared to the budget estimates of FY2020-21. In FY2020-21 expectations of marginal revenue surplus were not fulfilled and instead the revenue deficit widened to a significant 4% of GSDP as the States incurred higher revenue expenditure as they spent on the COVID-19 responses and healthcare facilities. The States had been assiduously guarding the fiscal glide path, and with exceptions of the years mentioned above, had brought the combined gross fiscal deficit below the FRL target of 3%. The fiscal slippage in these years though warranted, will make the reversal to the fiscal discipline difficult.

Liquidity management of States: We consider data since July 2018 to December 2021 for assessment of States which have been in WMA for more than 10% of the total duration in these three years. The data is presented below, and reflects on the last three years of States liquidity situation. The years of the pandemic saw financial accommodation being given to the States by the RBI through enhancing the Ways and Means Advances (WMA) and Over Draft (OD) limits. The interest rate on WMA for three months is equal to the Repo rate and beyond three months a rate of one per cent over and above the Repo rate. Over Draft facility, if availed up to 100 per cent of WMA limits and attracts a rate of 2 per cent over and above the Repo Rate and if it is availed beyond 100 per cent of the WMA limit, the interest rate is 5 per cent above the Repo rate.





Source: RBI

Amongst the major States, Andhra Pradesh and Telangana are frequent users of the WMA and the Overdraft facilities. This could possibly be a consequence of the recent carving up of the new state of Telangana. Nonetheless, as a per cent of the total time, the WMA usage for Andhra Pradesh was at 65% of the time period and Over Draft was used up 27% of the time. While for Telangana it was 49% for WMA and 21% for Over Draft. In the NE&H States, Manipur was in WMA for 54% of the time period under consideration and it used the Over Draft facility for 26% of the time. Over Draft facility or OD as it is known, is a means for States to borrow funds at a rate which is over and above the Repo Rate by 1%, and is availed only after the WMA limit has been exhausted. The data above also reflects the fact that there is a select group of States which resorts regularly to borrowing from the WMA and the OD facility, sometimes at punitive rates as the situation warrants.

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