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Occasional Report: State Finances

State Finances & Fiscal Reforms

Highlights:

- ***The RBI report on State Finances FY2024-25 lays out the panorama for the next generation of reforms in the evolving economic and geopolitical environment.***
- ***The report has also undertaken a comprehensive assessment of the fiscal reforms taken by the states over the last two decades.***
- ***As the overall level of debt for states remains above the 20 per cent mark prescribed by the FRBM review committee, the recent doling out of state subsidies is a cause of concern.***

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The Macroeconomic Backdrop: As the second tier in the federal structure of the Indian economy, States play a crucial role in the growth and development of the country. The first decade of the new millennium witnessed major fiscal reforms for the Center and the States, with the adoption of fiscal rules such as the Fiscal Responsibility and Budget Management, (FRBM Act) 2004 for the Central Government and similar fiscal rules for States termed as the Fiscal Responsibility Legislations (FRLs).

The RBI report highlights how the adoption of fiscal rules led to better fiscal management for States which were able to curb their fiscal imbalances over time and also reached closer to the ideal of debt sustainability. States' gross fiscal deficit declined from an average of 4.3 per cent of GDP during FY1998-99 to FY2003-04 to 2.7 per cent during FY2004-05 to FY2023-24. Barring the crisis periods of COVID-19 most of the States have been able to maintain the fiscal target set out by them indicating responsible fiscal management. However, while State level debt has declined in tandem from 31.8 per cent of GDP at end-March 2004 to 28.5 per cent of GDP at end-March 2024, it remains significantly above the 20 per cent mark recommended by the FRBM review committee (2017).

The States' have been prudent so far about the quality and pace of spending. However, in the recent past there has been an increasing proclivity on the part of State governments to offer cash transfers and subsidies to sections of the general public. These transfer payments indicate a move away from fiscal discipline and prudence with the risk of losing the hard-earned victory in terms of quality of spending. Given the recent slowdown in growth, and knowing the inflationary impact of fiscal profligacy, it is imperative that a disciplined approach is enforced for State finances. RBI reviews and offers its analysis on the fiscal rules that States have adopted to rein in their respective fiscal deficits, in which many States have been successful over time.

Fiscal Responsibility Legislations (FRLs): Following the adoption of the FRBM Act of 2003 by the Government of India, the States adopted their respective FRLs with the objective of designing and implementing a rule based prudent fiscal management system. Fiscal rules can be classified into four categories, based on fiscal variables these rules impinge upon:

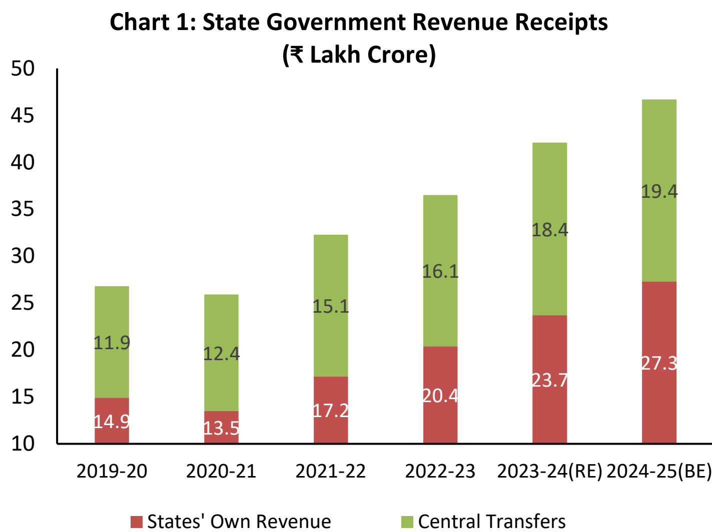
1. The budget balance rules (BBRs) aim at targeting either the overall fiscal balance or the cyclically adjusted fiscal balance;
2. Debt rules set ceilings for public debt-to-GDP ratios;
3. Expenditure rules restrict total or specific government spending; and
4. Revenue rules aim to control revenue through taxation limits or by ensuring minimum receipts

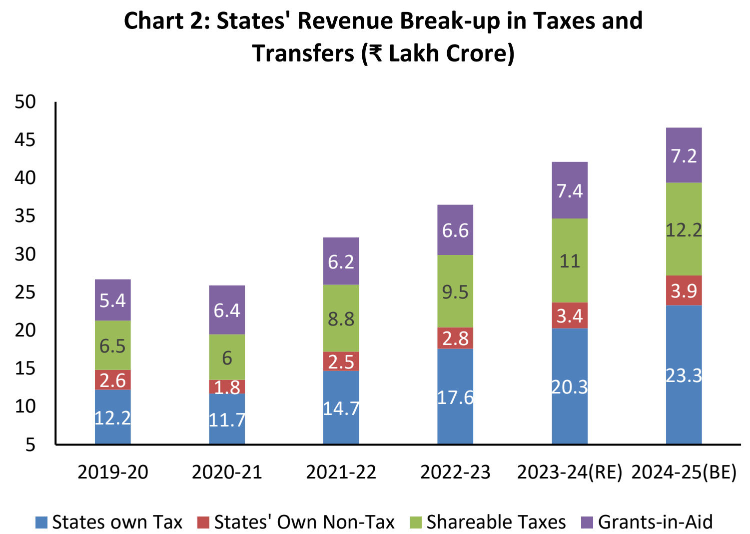
The FRBM Act of the Centre and FRLs of the States follow a two-pronged approach with a deficit rule and set a pre-defined debt-to-GDP ratio target. The States have adopted fiscal management principles such as containing the fiscal and revenue deficits within prescribed limits, maintaining the debt stock at a sustainable level, using borrowed funds for productive use and capping guarantees within an indicative ceiling.

The most important fiscal reform to be implemented post the adoption of the FRLs, was the Goods and Services Tax (GST) in July 2017. Expenditure reforms for States also included the shift from the Old Pension Scheme (OPS) to New Pension Scheme (NPS), move towards Direct Benefit Transfer (DBT) and implementation of a Single Nodal Agency (SNA) for the Centrally Sponsored Schemes (CSS). Market borrowings have become the dominant source of the State's deficit financing needs, increasing from a measly 17 per cent in FY2005-06 to 79 per cent in FY2024-25 (BE).

State Revenues-Decomposing the Revenue Streams: Overall revenue receipts had declined in FY2022-23 owing to lower tax devolution and grants-in-aid from the Centre, while States' own tax revenue saw a robust growth driven by robust collections from stamp and registration fees, States' goods and services tax (SGST), taxes on vehicles and duties on electricity. The lower receipts under grants-in-aid from the Centre were attributed to a decline in post-devolution revenue deficit grants. States' own tax revenues have improved over time with the important tax buoyancy improving from an average of 0.86 during FY2012-13 to FY2019-20 to an average of 1.44 post pandemic.

Non-tax revenues remained stable in FY2022-23. Non-tax revenues increased in FY2023-24 due to the higher collection from the renewal of existing mining leases and mining auctions. The decline in grants from Centre can be attributed to the cessation of GST compensation and the waning of Finance Commission grants. For FY2024-25, States' have budgeted an increase in revenue receipts by 1 percentage point to 14.3 per cent of GDP.





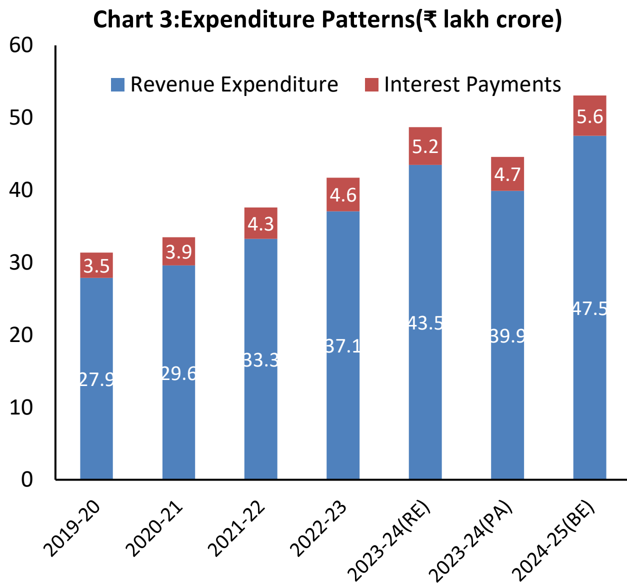
Source: State Finances : A study of Budgets of 2024-25

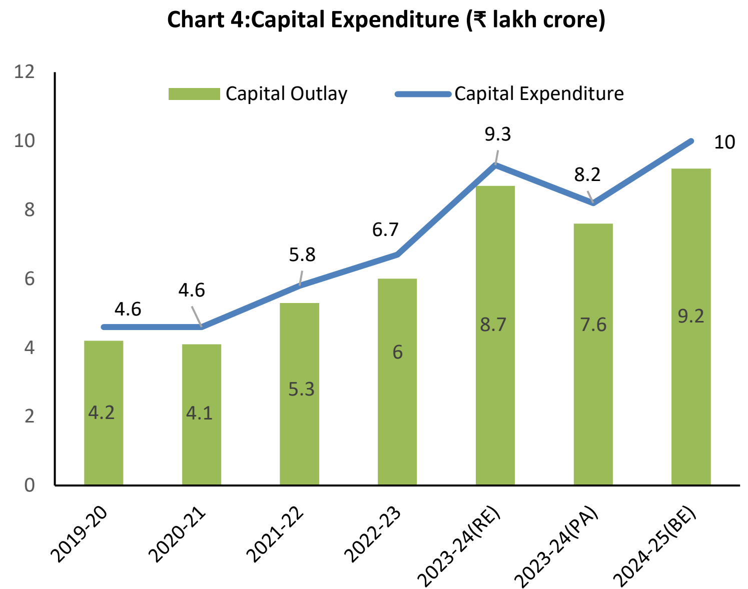
States have relied more on central transfers as against their own revenues especially post COVID-19, when local as well as country-wide economic activity saw a sharp decline affecting both tax and non-tax revenues. As of FY2024-25, as per the States' budget estimates, ~42 per cent of the State finances depend on the central transfers, which include the tax devolution of 41 per cent from the pool of GST collections, and grants-in-aid transferred from the Centre to the States largely for Centrally Sponsored Schemes (CSS).

Along with the GST allocation from the Central Government, States' own taxes which include SGST and stamp duties, registration charges and excise duties have shown a decent CAGR of ~11 per cent during the period FY2019-20 to FY2024-25. This rate of growth is also mirrored in the SGST growth over the same period. While the prescription for the future for most States would be to depend more on their own sources of tax revenues, for some States which are impaired by difficult geographical locations, this would be difficult to achieve and hence special attention by the Center is reflected in the inter-state variations in the grants-in-aid.

State Expenditures: Are States Spending for Growth? While revenue receipts of States' have grown, State expenditure patterns have changed in many ways especially since the onset of the pandemic, with more emphasis on States subsidies. States' revenue expenditure declined for the second consecutive year since FY2022-23, falling close to its pre-pandemic ratio with moderation in both developmental and non-developmental categories. Developmental expenditure such as on medical and public health, natural calamity relief and the agriculture sector declined sharply with the ebbing of the pandemic while that on housing and social security increased. Non-developmental expenditure decline was mainly driven by lower spending on committed expenditure components like interest payments, administrative services and pensions. Revenue expenditure declined by a further 0.3 percentage points to 13.5 per cent of GDP in

FY2023-24(PA). This trend is expected to reverse in FY2024-25, with revenue expenditure slated to increase to 14.6 per cent of GDP.





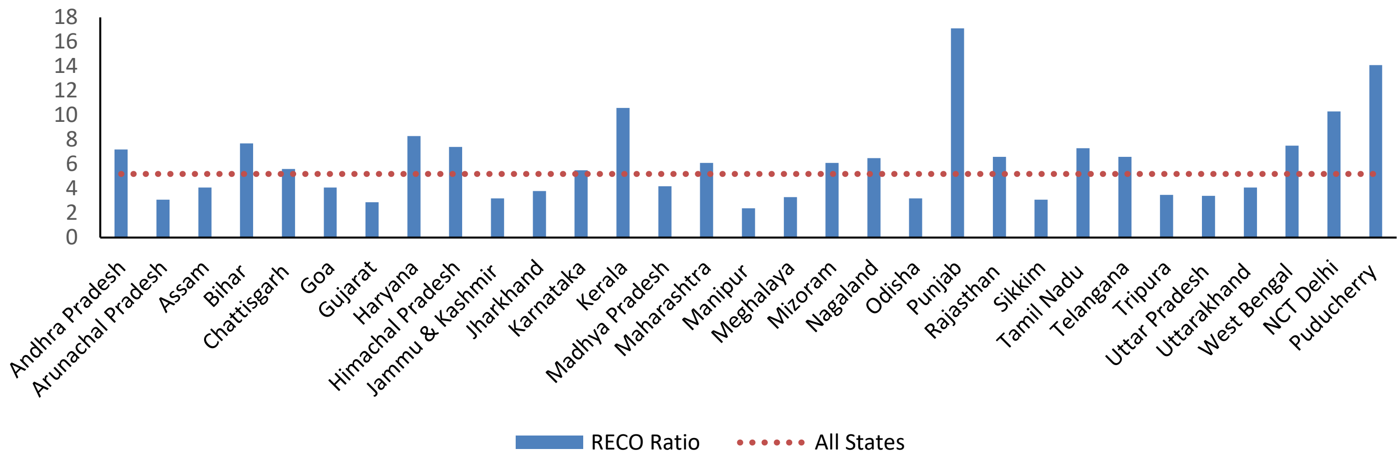
Source: State Finances : A study of Budgets of 2024-25

Capital expenditure increased marginally in FY2022-23 primarily due to higher loans and advances extended by States for asset creation purposes. Capex increased to 2.8 per cent of GDP in FY2023-24 (PA) from 2.5 per cent in FY2022-23. This was facilitated by advance payment of tax devolution and enhanced allocation under the Centre's scheme for special assistance to States for Capital Expenditure. The disbursement increased from ₹11,000-15,000 crore in FY2020-21 and FY2021-22, to ₹81,195 crore in FY2022-23 and further to ₹1,09,554 crore in FY2023-24. Even after excluding these interest free loans from the Centre,there has been a steady increase in capital outlays of the States' since FY2021-22.

There is significant inter-state variation seen in these loans over FY2022-23 to FY2023-24 varied from 3.9 percent (Odisha) to 50.6 per cent (Andhra Pradesh). States' have budgeted to increase capex by another 0.3 percentage point to 3.1 per cent of GDP in FY2024-25. A higher capital outlay has stronger multiplier effects on medium term growth prospects.

There is also significant interstate variation in the RECO ratio, which measures the proportion of revenue expenditure vis-à-vis capital outlay. There has been a welcome decline in the RECO ratio overall for all States from 6.3 in FY2021-22 to 5.2 in 2024-25(BE), though some of the States are significantly above the average, such as Punjab with a RECO ratio of 17.1 per cent, indicating the State's poor quality of expenditure. There are some States and UTs with a ratio above 10, such as Kerala, Puducherry and NCT Delhi.

Chart 5: State-Wise RECO Ratio for 2024-25 (BE)



Source: State Finances : A study of Budgets of 2024-25

Revex and Capex Gap and the effect of Multipliers: Revenue expenditure and capital outlay multipliers of States have been estimated in the RBI report, over a period from 1990-91 to 2023-24 with consolidated data of 31 States. The results indicate that:

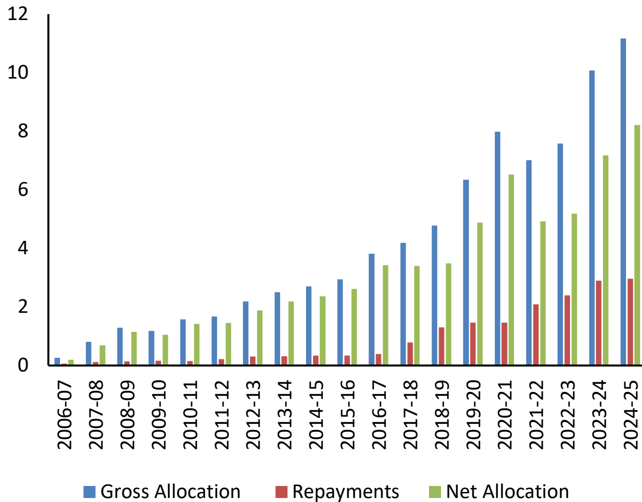
i. The cumulative revenue expenditure multipliers are almost a third of those for capital outlay (1.43 versus 3.84);

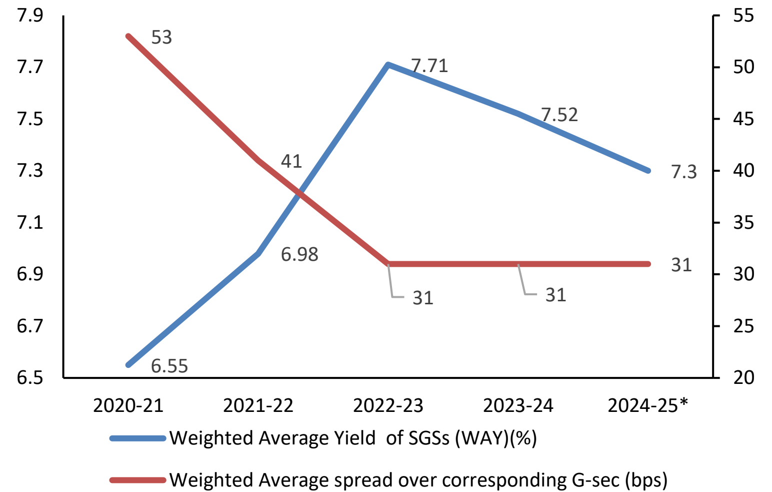
ii. The effects of revenue spending shocks last only for one year while those of capital outlays persist for a relatively longer period (5 years);

iii. The multiplier values are broadly comparable with the ranges suggested in the literature; and

iv. The analysis confirms that the short-term loss in growth from moderation in revenue expenditure is outweighed by the medium-term gains from higher capital outlay.

State Government Borrowings: So far, the fiscal discipline that has been followed by States over the years has not been reflected in the way the State borrowings have been announced. There is significant variation in the size of borrowings announced vis-à-vis the actual amounts borrowed. For the year FY2024-25, States have budgeted ₹11.17 lakh crore as gross market borrowings, and during April-September their borrowings increased by 7.7 per cent over the previous year, but the consolidated actual borrowings by all the States generally remained lower by ~7-25 per cent than the indicative calendar.





Source: State Finances : A study of Budgets of 2024-25

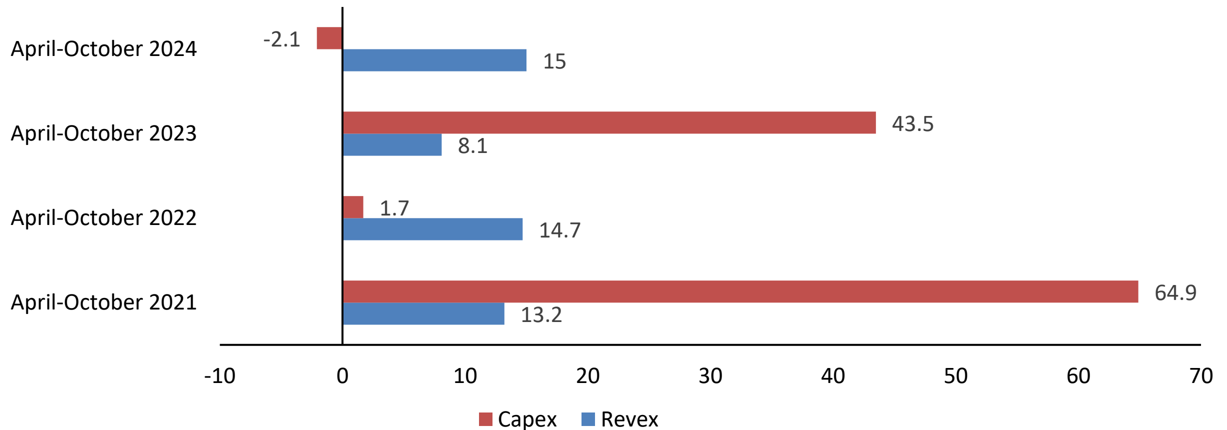
Net market borrowings of States rose by 38.2 per cent to ₹7.17 lakh crore in FY2023-24. States have also managed the number of re-issuances in their overall market borrowings, which is a necessary step towards debt consolidation. RBI reports 49 re-issuances in a total of 782 issuances i.e. 6.3 per cent, as compared to 45 re-issuances i.e. 7.4 per cent in FY2022-23.

As far as the maturity profile is concerned, the 10-year maturity has a share of 18.6 per cent in FY2023-24, significantly lower as compared to 27.9 per cent in the previous year. The remaining 81.4 per cent was spread across maturities ranging from 2 to 40 years and 57.6 per cent of outstanding SGSs were in the residual maturity bucket of five years and above. In terms of cost of borrowings, the weighted average yield has declined to 7.52 per cent in 2023-24 from 7.71 per cent in the previous year. The weighted average spread over comparable maturity G-Sec was unchanged at 31 basis points. In H1 FY2024-25 yields softened due to both domestic and global factors.

State's fiscal outlook FY2024-25: Due to a contraction in SGST collections, the largest driver of tax revenues, and a contraction in non-tax revenues, States' GFD during April-October 2024-25 has increased to 54.6 per cent of budget estimates, as compared to 48.7 per cent during the corresponding period in FY2023-24. Additionally, States' revenue expenditure grew faster at 15 per cent during April-October 2024-25. In contrast, capital expenditure declined owing to base effect and the impact of the model code of conduct imposed during general elections.

The outlook for States remains favourable in light of the robust pace of economic activity, aiding revenue buoyancy. The States' have managed to rein in revenue expenditure to 15 per cent during April-October 2024-25, which is below the full year budget estimates of 19.2 per cent. Aided by the 50 year interest free loans given by the Centre, capital outlay of States is expected to recover from the sluggishness witnessed during the first half of the year.

Chart8: Growth in Revenue & Capital Expenditure (Per Cent)



Source: State Finances : A study of Budgets of 2024-25

State Debt Sustainability: In terms of actual amounts, the total stock of outstanding debt has grown from ₹32.6 lakh crore to 2.8 times of that amount at ₹93.9 lakh crore over the course of the decade. States' outstanding liabilities declined from 28.2 per cent of GDP by end March 2023 from the peak of 31 per cent during pandemic times at end-March 2021, driven by consistent efforts by the States on fiscal consolidation. This ratio is however slated to increase to 28.8 per cent by March 2025.

Chart 9:States' Outstanding Liabilities Amount & Annual Growth (₹ lakh crore & per cent)

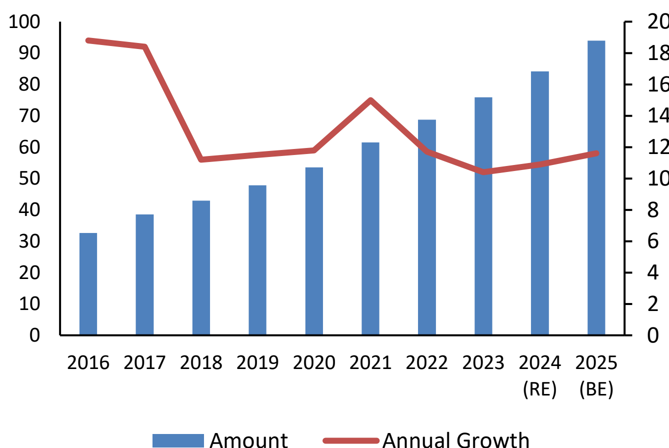
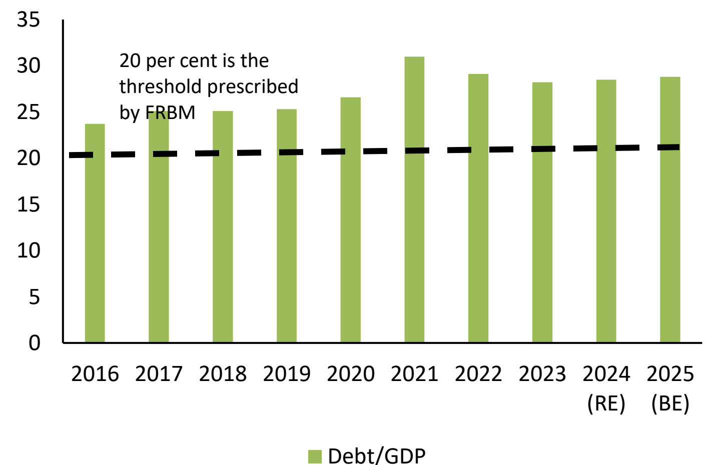


Chart 10:States' Outstanding Liabilities-Debt/GDP (per cent)



Source: State Finances : A study of Budgets of 2024-25

While the debt-service ratio, which is defined as the interest payment to revenue receipts (IP-RR) ratio, has been declining gradually. The level of total outstanding stock of debt remains uncomfortably high at ~26-28 per cent, as compared to the 20 per cent level of debt threshold prescribed by FRBM. The annual growth in debt reached a peak of 15 per cent during the COVID-19 years FY2020-21, but has slowly declined to around 12 per cent.

In terms of sustainability of debt, the ratios are still higher than warranted despite efforts by the States to control the fiscal spending. Quality of expenditure has also improved over the past decade or so with the ratio of revenue expenditure to capital outlay declining with revenue expenditure at 0.29 per cent of GDP and capital outlay at 0.35 per cent of GDP.

Fiscal Indicators of States: For FY2024-25 States have budgeted an overall GFD-GDP ratio of 3.2 per cent which is higher than the previous year's 2.9 per cent, and a revenue deficit of 0.2 per cent, flat as compared to the previous financial year. In terms of actuals, the aggregate GFD for all states is estimated as per various State budgets at ₹10.4 lakh crore for FY2024-25, higher than the ₹8.7 lakh crore in FY2023-24.

Chart 11: Major Fiscal Deficit Indicators (₹ Lakh Crore)

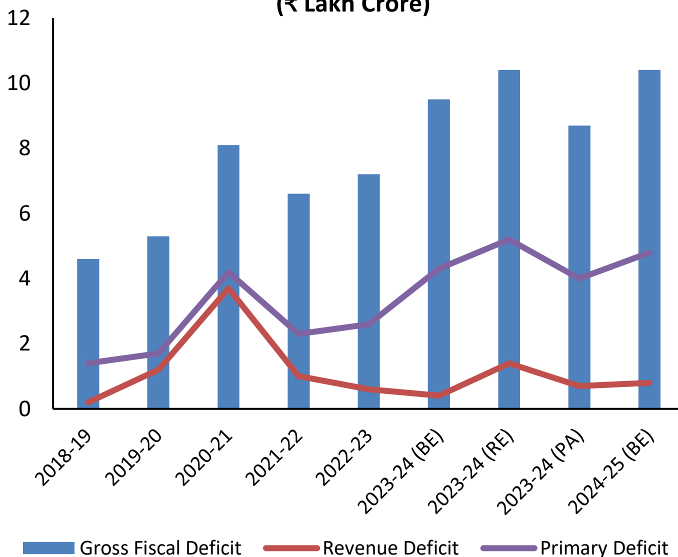
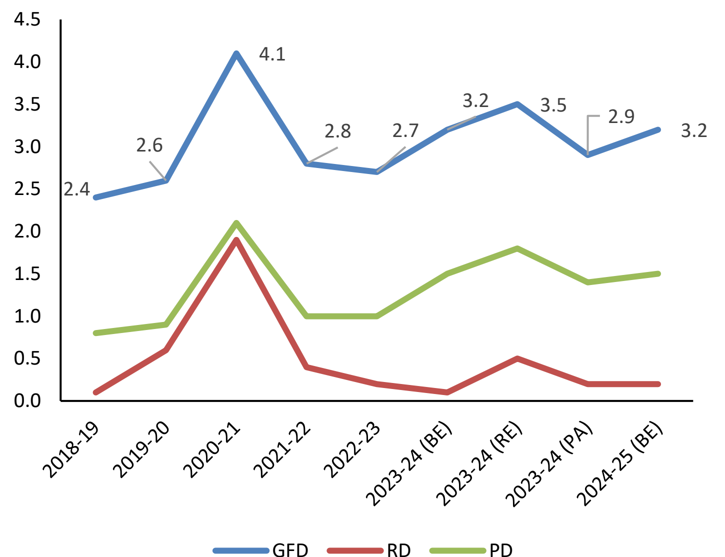


Chart 12: Fiscal Indicators as a % of GDP



Source: State Finances : A study of Budgets of 2024-25

The COVID-19 years posed an unprecedented challenge for the Centre as well as the States, as tax revenues were not forthcoming owing to a complete breakdown of economic activity, hence the economy had to be pump-primed with public expenditure and this resulted in an aberration in terms of fiscal deficit in FY2020-21 at 4.1 per cent of GDP, the highest since 2011-12, as an aggregate of all States and Union Territories. Barring this aberrant episode States' have been able to keep overall fiscal deficit below the 3.5 per cent allowing for significant interstate variation.

GST & Fiscal Convergence: The introduction of the GST regime has indeed led to the minimization of the tax variation among States and the Gini coefficient and the Coefficient of Variation (CV) show a decline in interstate disparities in own-tax-GSDP ratios after the implementation of GST. Additionally, GST has improved tax performance across States, and States with lower own tax revenue-GSDP rates witnessed stronger growth in tax revenues post GST. The report indicates that GST has helped the low-performing states to catch up, fostering fiscal convergence in the post GST period.

Fiscal Reforms -The Way Ahead: Against this backdrop, RBI recommends next generation reforms and fiscal rules which combine the medium-term fiscal sustainability objective with short term flexibility allowing State governments more maneuverability in dealing with exogenous economic shocks.

- Refinement of States' taxation systems with the help of artificial intelligence and machine learning will not only lead to better systems but can augment the State's tax capacity as well as their non-tax revenue by timely revision of user charges, particularly for power, water and transport services.
- Adherence to the golden rule of public finance, central sponsored schemes can be further rationalized which can make room for more productive expenditure while confirming to their respective FRL targets.
- The RBI recommends an urgent review of the expenditure on subsidies to free up resources for increased investment in agriculture, health, education, research and development, and rural infrastructure which will create additional jobs, and help in reducing poverty on a sustainable basis.
- Increased focus on fiscal transparency and disclosure practices would help States to achieve lower deficits and debt ratios. Credibility of states will increase if they disclose time to time changes in:
    - Accounting standards;
    - Pension liabilities worked out on an actuarial basis;
    - Information on supplementary demand for grants and its end uses; and
    - Updated record of contingent liabilities.
- Next generation reforms must also focus on improved fiscal data generation and dissemination processes.

- State electricity distribution companies remain a drag on state finances, with total accumulated losses of ₹ 6.5 lakh crore, by 2022-23, (~2.4 per cent of GDP). Efforts to enhance productivity, reduce transmission and distribution losses, rationalizing tariffs in accordance with underlying cost of power supply, unbundling the electricity supply industry, and privatizing generation and distribution remain critical to improve the quality of state finances.

- States need to expedite and refine the process of appointment of State Finance Commissions (SFCs) with time bound release of their recommendations, so that timely and adequate resources are available to the local bodies.

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