STATE OF STATE FINANCES

November 2022

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Debt levels in several states higher than the recommended limit

GST compensation ends; revenue lower compared to earlier tax regime

Rollback of pension reforms may increase expenditure in the long term

In 2022-23, expenditure of states on aggregate is expected to be 1.5 times that of the centre. States have also assumed an important role in government capital expenditure. In recent years, economic slowdown followed by onset of COVID-19 pandemic worsened the financial position of state governments. They have relied on borrowings to help sustain the expenditure level during this period. This has meant a sharp increase in outstanding liabilities and higher deficit levels than usual. Given higher debt levels than many comparable economies, fiscal consolidation has been identified to be a key long-term target for India. This would require recalibration of expenditure plans as well as renewed efforts towards increasing revenue in coming years. Since the introduction of GST in 2017, State GST has become the largest source of own tax revenue for States (about 42%). Revenue realisation has been lower than the pre-GST regime; which, according to the 15th Finance Commission, was due to both structural and operational reasons. GST compensation, which guaranteed 14% growth in SGST collection, was discontinued in June 2022. This is expected to create a challenge for maintaining revenue level in some states.

In 2022, some state governments announced the decision to roll back pension reforms, carried out about two decades ago. These reforms were undertaken in wake of an alarming increase projected in the pension expenditure of state governments. These decisions may have repercussions for committed expenditure in the longer term. Another persistent challenge for state finances has been the financial performance of state-owned power distribution companies. These companies have continued to make losses, requiring state governments to provide them with grants and guarantee their market borrowings. Many centrally sponsored schemes have been rationalised in the last two years, as their implementation period are co-terminus with finance commission periods. While the number of such schemes have come down, the quantum of transfer under them continues to be at a similar level as earlier. Continuance of such schemes raise questions about fiscal decentralisation and equity in central transfers.

In this backdrop, this report analyses the finances of all states, and union territories of Jammu and Kashmir, Delhi, and Puducherry, based on their budget documents. The following abbreviations have been used for states in the charts throughout the report.

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

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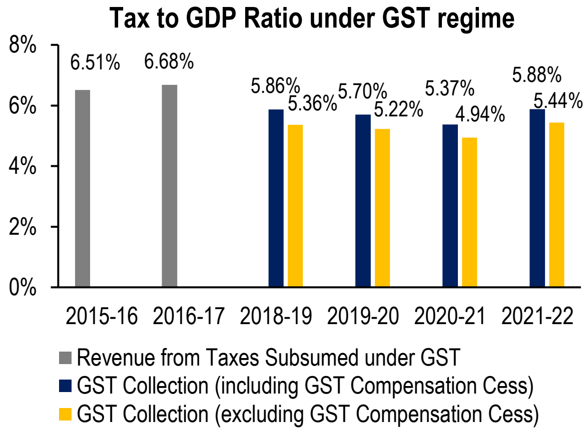
DEVELOPING THEMES IN STATE FINANCES

Need for fiscal consolidation in coming years

As per the recommendation of the 15th Finance Commission, the unconditional fiscal deficit limit for states will be back to the usual limit of 3% of GSDP from 2023-24. Many states continue to observe substantial revenue deficit. The need to lower deficits may have become more pronounced as debt levels in many states are higher than the recommended limit. The aggregate debt of the central and state governments is projected to be above 85% of GDP in 2022-23.

Revenue collected under GST continues to be lower compared to pre-GST regime

After five years of its implementation, the revenue collected under GST continues to be lower when compared to revenue from taxes subsumed under GST. While states' need for compensation reduced in 2021-22 as compared to 2020-21, they were still dependent on it to meet the protected revenue growth rate. After the expiry of the compensation period in June 2022, states with a greater reliance on compensation such as Punjab, Puducherry, and Goa may be adversely impacted.



Shifting to old pension scheme may increase pension expense for states in the future

Several states have announced their decision to bring back the old pension scheme. Pension reforms were implemented about two decades ago to reduce the burden on the finances of central and state governments. By reverting to the old pension scheme, states may reduce their pension expenditure in the near term, but incur higher pension expenditure in the longer run.

Improvements in taxation of property and electricity could bring additional revenue

There may be scope for improvements in taxation of property and electricity. The 15th Finance Commission had noted that certain richer states lag behind in collection of stamp duty and registration fees. India also lags behind significantly in collection of property tax, which is the most significant source of own tax revenue for local bodies. Seven states did not budget any revenue from taxes and duties on electricity as per revised estimates of 2021-22.

Number of CSS schemes pruned, however, spending on CSS by Centre at similar level

Between 2015-16 and 2022-23, grants for centrally sponsored schemes (CSS) have ranged between 25%-29% of the total transfers to states. While the number of CSS have come down owing to rationalisation carried out by the central government, the overall allocation for these schemes have stayed at a similar level. New schemes have since been announced in areas such as health and education. Continuance of CSS in state list subjects has raised questions about their overlap with responsibility of states, and implications for fiscal decentralisation and equity in transfers.

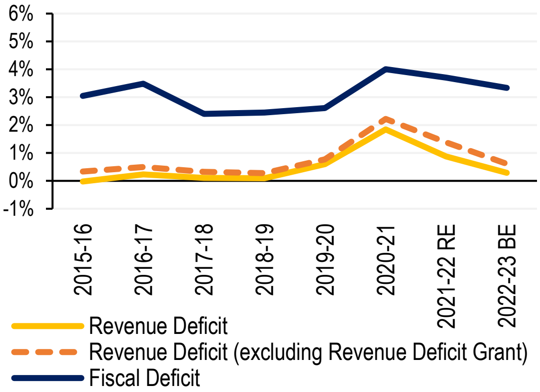
Developments in the power distribution sector pose risks to state finances

State-owned discoms registered cumulative losses of about three lakh crore rupees between 2017-18 and 2020-21. The liabilities of these discoms are contingent liabilities of the state government. Poor financial situation of discoms may pose risks to government finances if the state governments have to bail out these discoms.

Need for fiscal consolidation in coming years

Successive Finance Commissions have recognised the following rules as cornerstones of fiscal management for states: (i) keeping annual fiscal deficit within 3% of GSDP (the gap between total expenditure and total receipts), and (ii) eliminating revenue deficit (the gap between revenue expenditure and revenue receipts).[1,2] Respective FRBM Acts of states provide for these targets. Higher fiscal deficit levels were permitted between 2020-21 and 2022-23 to supplement the government's response to COVID-19 and the economic downturn.[3,4] In 2015-16, states on aggregate had observed a marginal revenue surplus, however, since then, their revenue deficit has increased (Figure 1).

Figure 1: Deficit levels have risen in recent years (as % of GDP)



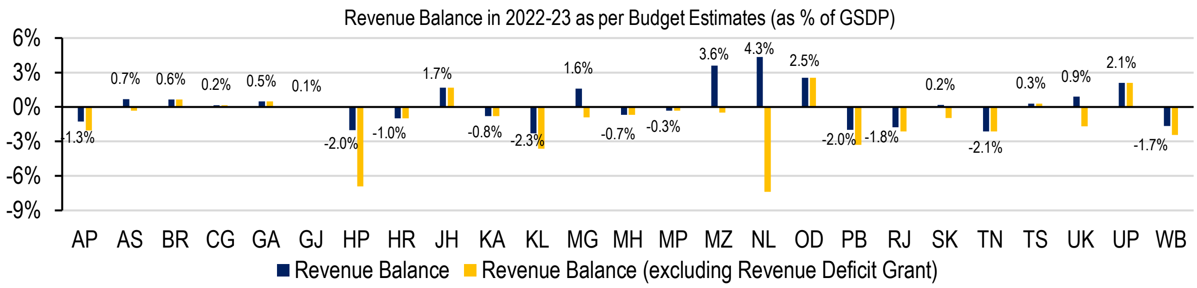
Sources: State Budget Documents; Union Budget 2022-23, RBI, MoSPI, Report of the 15th Finance Commission; PRS.

As per the recommendations of the 15th Finance Commission, states need to bring the fiscal deficit down to 3% of GSDP from 2023-24. Additional borrowing worth 0.5% of GSDP may be available in 2023-24 and 2024-25 upon undertaking certain power sector reforms. The need for a lower deficit may have become more pronounced, as debt is higher than the recommended limit of 20% of GDP in 30 states as of March 2022 (see Page 17).[5] The aggregate debt of the central and state governments has risen sharply in recent years, and is projected to be above 85% of GDP in 2022-23, much higher than the recommended level of 60% of GDP.[2,5]

Fiscal deficit is essentially the sum of capital outlay (spending on creation of assets), and revenue deficit (revenue expenditure above revenue receipts) given negligible capital receipts. States plan revenue deficit levels according to their priorities. A revenue deficit signifies that borrowings are needed to meet recurring expenditure such as salaries, pensions, interests, and subsidies, which do not lead to any creation of assets. Thus, if a state does not bring down the revenue deficit, the space for capital outlay will stand reduced. This may have adverse implications for economic growth.[6]

In 2022-23, as per the recommendations of the 15th Finance Commission, the central government is estimated to provide a grant of Rs 86,201 crore to states to eliminate the revenue deficit.[7] There are seven states which are expected to observe a revenue deficit after accounting for the grant. These are Andhra Pradesh, Himachal Pradesh, Kerala, Punjab, Rajasthan, Tripura, and West Bengal. If no such grants were to be provided and expenditure plans were to hold, six more states would have observed revenue deficit. These are Assam, Meghalaya, Mizoram, Nagaland, Sikkim, and Uttarakhand. Over the next three years, these grants are to substantially reduce (Annexure I). In addition, there are five more states which expect revenue deficit, although they will not receive any grant on this account – Haryana, Karnataka, Maharashtra, Madhya Pradesh, and Tamil Nadu. These states will need to either augment revenue receipts or cut back revenue expenditure to manage their revenue deficit level.

Figure 2: 12 states have estimated a revenue deficit in 2022-23

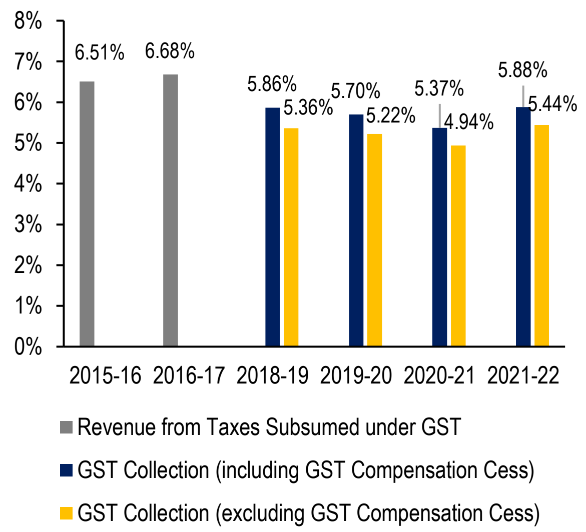


Note: Delhi, Puducherry, and Tripura not shown as 2022-23 GSDP estimate not available for them. Tripura expects a revenue deficit. Arunachal Pradesh (21%), Jammu & Kashmir (15.1%), and Manipur (15.4%) not shown to maintain the scale, as they have estimated a very high revenue surplus as % of GSDP mainly owing to high central transfers.
Sources: State Budget Documents; RBI, MoSPI, Report of the 15th Finance Commission for 2021-26; PRS.

Revenue collected under GST continues to be lower compared to the pre-GST regime

The implementation of the Goods and Services Tax (GST) introduced two key changes in India's indirect tax regime. First, the principle of taxation changed as GST is collected at the place of supply of goods and services, compared to the earlier tax regime where tax was collected at the source. Secondly, GST subsumed a number of taxes which were being levied by the central and state governments. At the central level, the taxes subsumed included central excise duty, service tax, and central sales tax, while at the level of the states these included sales tax, entertainment tax, and octroi.[8]

Figure 3: Tax to GDP ratio under GST regime



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

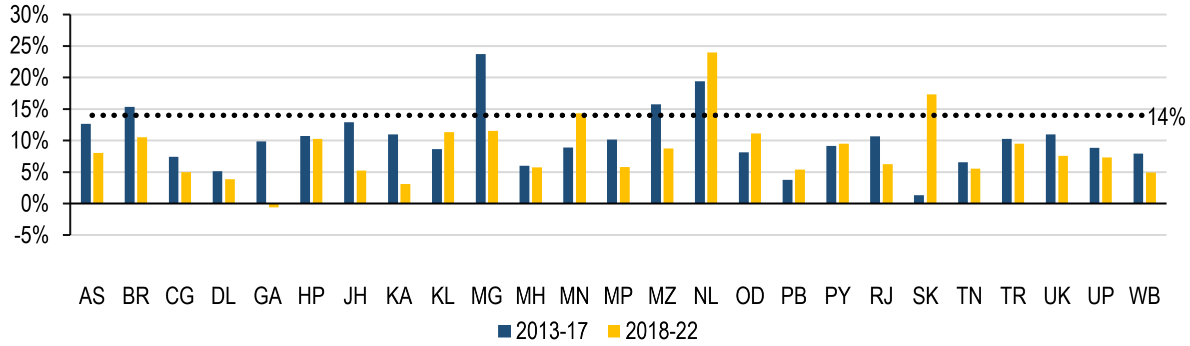
Compared to the pre-GST regime, the revenue collected from GST, as a percentage of GDP, continues to be lower. In 2016-17, the revenue from taxes subsumed under GST was 6.68% of GDP. In 2021-22, revenue collected from GST was 5.88% of GDP. If collections from GST compensation cess are excluded, GST revenue collection further fell to 5.44% of GDP. Compensation cess is levied on certain goods to compensate states for the loss in revenue from the implementation of GST. In 2015, the report on the revenue neutral rate and structure of rate under GST had recommended a revenue neutral rate of 15% to 15.5% under the tax regime.[9] The Reserve Bank of India (2019) estimated that the weighted average GST rate had declined from 14.4% in 2017 to 11.6% in 2019 through rationalisation of rates.[10]

The 15th Finance Commission had observed that the revenue neutrality of GST was compromised due to multiple tax rate reductions.[11] For restoring the revenue neutral rate, it recommended: (i) merging the tax rates of 12% and 18%, (ii) operating with a three-rate structure of a merit rate, standard rate, and demerit rate (up to 30%), and (iii) minimising exemptions.[11] One of the reasons for the relatively lower revenue collections under GST could also be due to slowdown in economic growth. Growth rate of nominal GDP had decreased from 11% in 2017-18 to 6.2% in 2019-20.[12] In 2020-21, nominal GDP contracted by 1.4% due to the impact of the COVID-19 pandemic and nation-wide lockdowns.[12] The 15th Finance Commission has recommended achieving a GST-to-GDP ratio (net of revenue from compensation cess) of 7% over the medium term.[11] Given that the compensation to states ends in June 2022, state GST collection needs to rise by 29% to reach this rate.

Revenue growth for many states was higher in the pre-GST regime

Figure 4 shows the annual growth rate of states' revenue from taxes subsumed under GST between 2013-14 and 2016-17. The figure compares it to the annual growth rate of revenue from GST between 2018-19 and 2021-22. In the pre-GST period, only a handful of states such as Bihar, Meghalaya, Mizoram, and Nagaland, had their revenue growing at an annual rate of more than 14% (which was the protected rate of revenue growth under GST). The growth rate of revenue under GST for some states was significantly lower as compared to the pre-GST regime. For instance, Bihar which registered a 15% annual growth in revenue between 2013-14 to 2016-17 from the taxes subsumed under GST, saw its revenue growth under GST decline to 10%. On the other hand, certain north eastern states, such as Manipur and Nagaland, observed higher revenue after the implementation of GST as compared to the revenue growth from the taxes subsumed under GST.

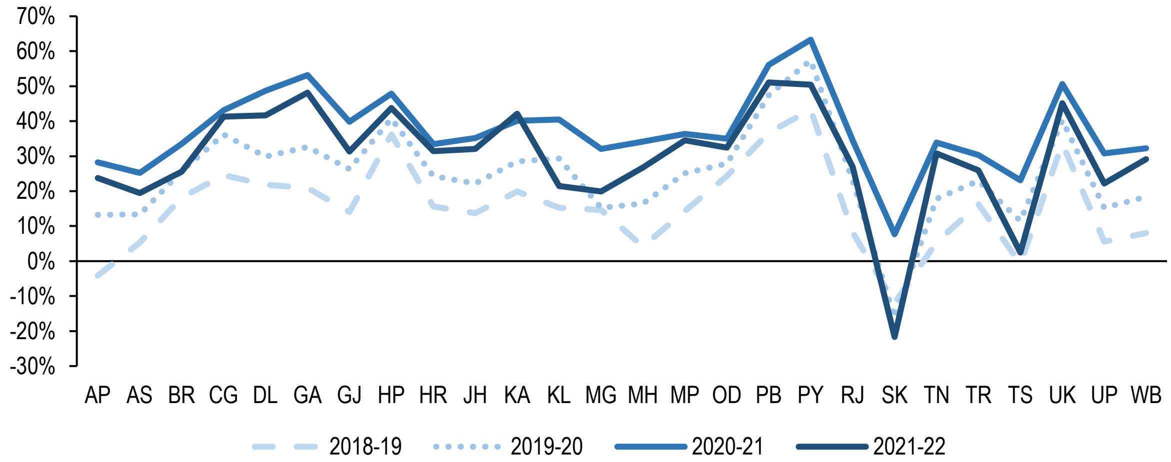
Figure 4: States' revenue growth before and after implementation of GST



Note: The chart excludes Arunachal Pradesh, Gujarat, and Haryana, as pre-GST revenue is not available. It also excludes Andhra Pradesh and Telangana due to bifurcation and Jammu and Kashmir as its status changed from a state to a UT.
Sources: GST Network; State Budget Documents; Comptroller and Auditor General of India; PRS.

The compensation needs of most states had increased between 2018-19 and 2020-21 (Figure 5). The compensation requirements were exacerbated due to the economic slowdown in 2019-20 and contraction of the economy in 2020-21 from COVID-19 related lockdowns. For 2021-22, the compensation needs of several states have reduced from the levels seen in 2020-21. This was driven by recovery in economic activity as the nominal GDP is estimated to grow by 19.5% in 2021-22.[12] Despite lower requirement of states in 2021-22 compared to 2020-21, it is important to note that they continued to depend on compensation for meeting the protected annual revenue growth of 14% under GST. After the expiry of the guaranteed compensation period in June 2022, revenue of states with a greater reliance on GST compensation, such as Punjab, Puducherry, Goa, Uttarakhand, and Himachal Pradesh, may be adversely impacted.

Figure 5: Compensation needs of states reduced in 2021-22 compared to 2020-21



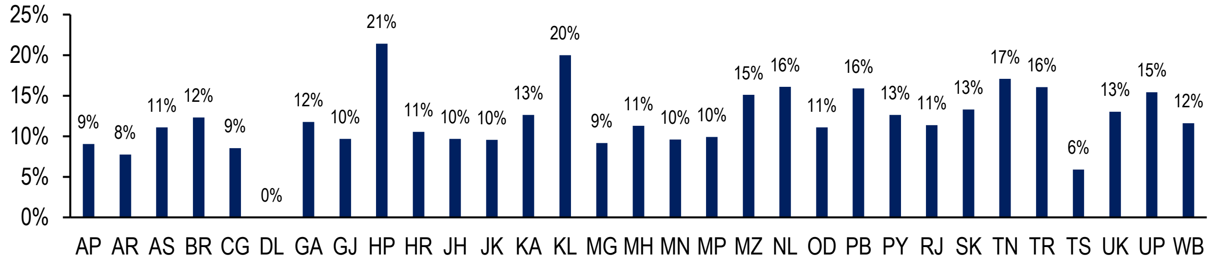
Note: For Andhra Pradesh, Bihar, Delhi, Goa, Karnataka, Puducherry, and Uttar Pradesh the compensation needs have been calculated based on the revised estimates of 2021-22 as presented in respective state budget documents. For the rest of the states, data from CAG has been used. States not requiring compensation not included. Jammu & Kashmir has not been included due to change in its status from state to UT.
Sources: GST Council; State Budget Documents; CAG; PRS.

The 15th Finance Commission had observed that improving the efficiency of GST will strengthen the finances of central and state governments.[11] This would have a larger impact on state finances as more than 70% of the total GST revenue accrues to the states (from SGST and devolution of CGST).[11] Certain issues related to GST include: (i) inverted duty structure, (ii) unavailability of invoice matching system, (iii) reliability of data under GSTN. These issues are discussed in detail in Annexure II.

Shifting to old pension scheme may increase pension expense for states in the future

Central and state governments engage a significant number of employees for rendering services. The governments provide pension benefits to retired employees. The payment of pensions and other retirement benefits by state governments form a part of their committed expenditure. These expenditures cannot be rationalised in the short term and keeping them in check may require reforms which usually show results over a longer term. In 2022-23, several state governments announced their decision to roll back pension reforms, which were carried out about two decades ago. We discuss its implications below.

Figure 6: Spending on pension and retirement benefits as percentage of revenue receipts in 2022-23



Note: Figures are as per budget estimates. In case of Delhi, the central government mostly bears pension liabilities.
Sources: State Budget Documents; PRS.

In 2000, the Old Age Social and Income Security (OASIS) Project Report observed that higher government spending on old age security had often been at the cost of spending on other important public goods.[13] This was also seen as a drain on government finances (see Annexure III).[13] The Report of the Group to Study the Pension Liabilities of the State Governments (2003) had noted that the continuation of the existing pension (defined benefit) scheme without any modification would be unsustainable and deteriorate states' financial position.[14] Pension payments as percentage of revenue receipts of states increased from 2% in 1980-81 to 11% in 1999-2000.[14]

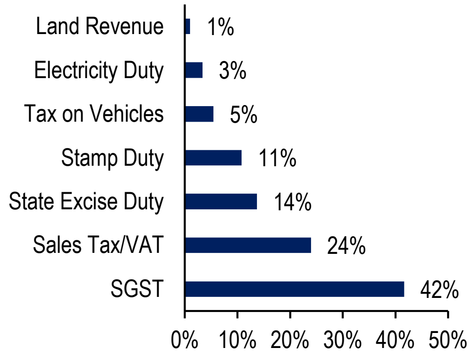
The architecture of government pensions in India changed with the implementation of the National Pension System (formerly new pension system) (NPS). This scheme was made mandatory for all central government employees (except the armed forces) joining from January 1, 2004. All state governments (except West Bengal) joined the new framework at different points of time. NPS changed the principle of pensions from a defined benefit scheme to a defined contribution scheme. Under a defined benefit scheme, an employee is entitled to a pension based on a defined benefit formula which may be calculated as a percentage of salary. This is paid out of the budget for the year. In a defined contribution scheme, the employee and the employer make contributions over the length of his service and the benefits post retirement depend on the balance in his account at the time of retirement. Thus, pensions are funded from a corpus which has been built over the duration of the employment. Under NPS, employees contribute a certain amount from their monthly emoluments (usually 10%) in a pension corpus. A contribution is also deposited by the government in the corpus.

Rajasthan, Chhattisgarh, and Punjab have announced that they will withdraw from NPS and re-implement the defined-benefit based old pension scheme.[15,16,17] Jharkhand has also decided to implement the old pension scheme subject to certain conditions.[18] Given that the current retirees from state government are primarily the beneficiaries of the old pension scheme, immediate financial strain will not be felt if states choose to implement the old pension scheme.[19] In fact, the pension spending of these states may even see a decline in the near to medium term as they would no longer have to provide for NPS contributions. In the case of Rajasthan, the state has reduced the contributions to NPS from Rs 2,610 crore in 2021-22 to Rs 270 crore in 2022-23. As a result, the state's overall spending on pension is expected to see a decline in 2022-23 as compared to the previous year. However, when the employees who joined after the implementation of NPS begin to retire from 2034 onwards, the costs of reverting to the old pension scheme will become more visible.[19] Adoption of the old pension scheme is expected to benefit the current generation at the cost of future generations.[19]

Improvements in taxation of property and electricity could bring additional revenue

Taxes other than SGST constitute about 58% of own tax revenue. Considering the need for fiscal consolidation, there may be a need for increasing revenue from other tax sources. Sales Tax/VAT and State Excise Duty are the two largest sources of revenue after SGST. These are collected from sale of petroleum products, and alcohol, respectively. These tax sources are already over leveraged across most states.[8] We discuss two taxes - Stamp Duty and Registration Fees, and Taxes and Duties on Electricity, where a wide inter-state variation is observed. This may indicate that there is a potential for revenue augmentation from these sources.

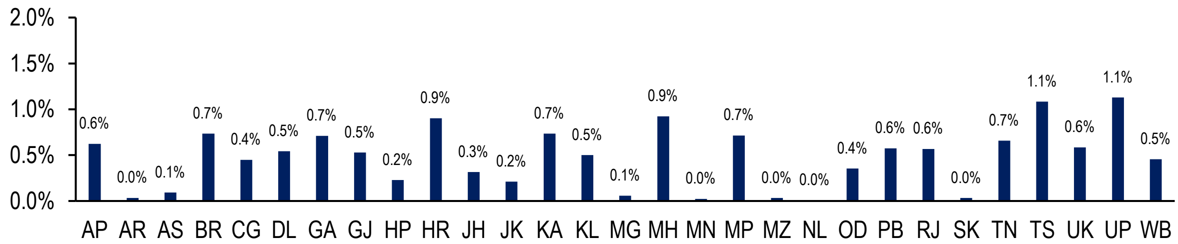
Figure 7: Composition of own tax revenue between 2018-19 and 2021-22



Note: SGST does not include GST compensation grants.
Sources: State Budget Documents of various years; PRS.

Stamp Duty and Registration Fees: The 15th Finance Commission had observed that some richer states, despite being known to have buoyant property transactions, lag behind the average in collection on this account.[8] This may be because of undervaluation of property at the time of registration.[8] It noted that guidance or fair value of land fixed by state governments are often significantly lower than the market value of land.[8] Addressing this may also help improve the collection of property tax (discussed further on next page).[8] India earns significantly lower on account of property tax as compared to developed countries (about 0.2% of GDP as compared to about 2%-3% of GDP in UK, USA, and France).[20]

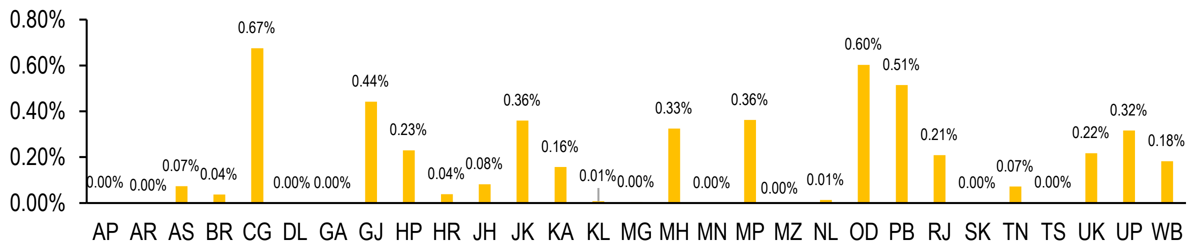
Figure 8: Stamp Duty and Registration Fees as % of GSDP (2021-22 RE)



Note: Tripura and Puducherry are not shown as GSDP estimates for these states are not available.
Sources: State Budget Documents; PRS.

Taxes and Duties on Electricity: This includes taxes and duties levied on captive generation and consumption of electricity. There are seven states which have not budgeted any revenue from taxes and duties on electricity in 2021-22 as per revised estimates. These are Delhi, Goa, Arunachal Pradesh, Manipur, Mizoram, Puducherry, and Sikkim. Mineral-rich states such as Chhattisgarh and Odisha estimate to earn the highest revenue on this account, to the tune of 0.6-0.7% of their GSDP. This may be on account of captive generation by industries. Other states with comparatively higher revenue on this account are Gujarat and Punjab. In case of Andhra Pradesh, Telangana and Kerala, the collection on this account is estimated to be less than Rs 100 crore or 0.01% of GSDP.

Figure 9: Taxes and Duties on Electricity as % of GSDP (2021-22 RE)



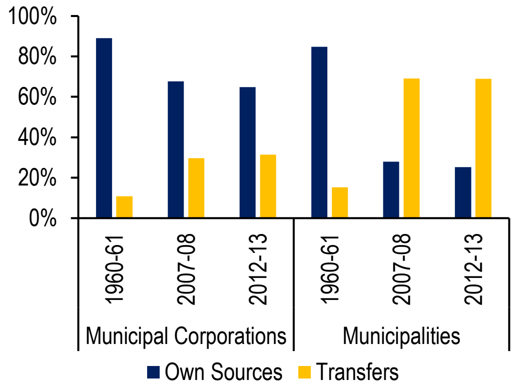
Note: Tripura and Puducherry are not shown as GSDP estimates for these states are not available.
Sources: State Budget Documents; PRS.

Rising dependence of municipal bodies on inter-government transfers and property tax

Municipal bodies provide services such as health care, education, and housing. The Constitution empowers states to authorise these bodies to levy taxes, duties, and fees.[21] In addition, state governments devolve taxes and provide grants as per the recommendations of the State Finance Commission.[22] The central government also provides certain grants to local bodies. Thus, the changing dynamics of municipal finances also has implications for finances of state governments.

Over the years, the share of transfers from central and state governments has increased in the overall revenue of municipal bodies (Figure 10). In case of municipal corporations, in 2019-20, transfers are estimated to account for 36% of revenue receipts of municipal corporations. Between 2017-18 and 2019-20, almost 90% of the total transfers to municipal corporations were from state governments and 10% from the centre.[23] RBI (2022) noted that municipal bodies are constrained in terms of resources in incurring expenditure.[23] As they are not granted liberal permission to borrow by respective states, their ability to finance spending through market borrowing is limited.

Figure 10: Evolution of municipal revenues (as % of total revenues)

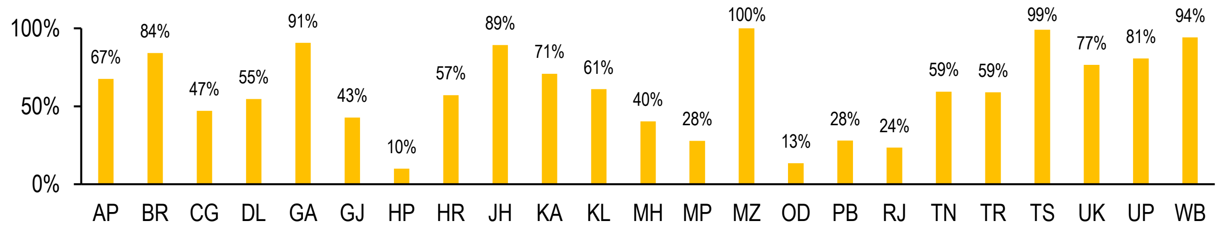


Sources: Zakaria Commission Report; Report on Municipal Finances, RBI; PRS.

Between 2017-18 and 2019-20, total expenditure of municipal corporations is estimated to increase from 0.68% of GDP to 1.05% of GDP (based on data of 201 municipal corporations across 27 states and UTs).[23] During this period, transfers are estimated to grow at 21%, higher than the growth in own revenue (14%). These trends may indicate increasing dependence on transfers to finance expenditure.

Own revenue sources of municipal corporations may be classified as: (i) own tax revenue sources such as property tax, water tax, and toll tax, and (ii) non-tax revenue such as fees and user charges, income from investments, and rental income from municipal properties. Property tax is the major source of own tax source with varying dependency across states (Figure 11). Property tax has become significant especially after the introduction of GST, as other sources of own tax revenue, such as octroi and entertainment tax were subsumed under GST. As discussed earlier, the collection of property tax at the national level in India is lower than developed countries. Apart from property undervaluation, the following have been highlighted as key issues: (i) policy inadequacy and ineffective administration, and (ii) outdated exemptions and sub-optimal tax rates.[23] RBI (2022) observed that the potential of property tax needs to be leveraged better by extending coverage, regularly revising tax rates, improving the assessment system, and raising administrative efficiency.[23]

Figure 11: Property tax as percentage of own tax revenue in 2019-20



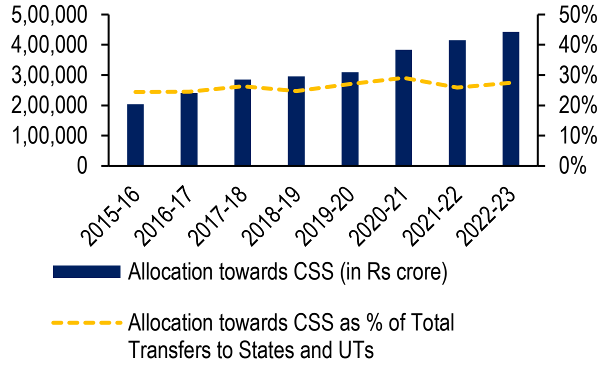
Note: Figures are as per budget estimates. Data pertains to 201 municipal corporations.
Sources: Report on Municipal Finances, RBI; MoSPI; PRS.

As per the recommendations of the 15th Finance Commission, local government grants by the central government are also linked to reforms in the property tax regime.[24] Only those urban local bodies will be eligible for grants, which have notified floor rates of property tax in 2021-22. From 2023-24, to be eligible, growth in property tax collection should be at least equal to the simple average growth rate of the state's own GSDP in the most recent five years.

Number of CSS schemes pruned; however, spending on CSS continues at similar level

A significant portion of transfers from the Centre comes in the form of grants for centrally sponsored schemes (CSS). Between 2015-16 and 2022-23, grants for CSS have ranged between 25%-29% of the total transfers to states. These are schemes formulated by the Centre, where the Centre provides certain matching grants for states to implement them. These schemes cover areas such as education, health, employment, rural and urban development, and social justice. Key schemes include MGNREGS, Jal Jeevan Mission, PM Awas Yojana, and National Health Mission.

Figure 12: Allocation towards Centrally Sponsored Schemes under Union Budget

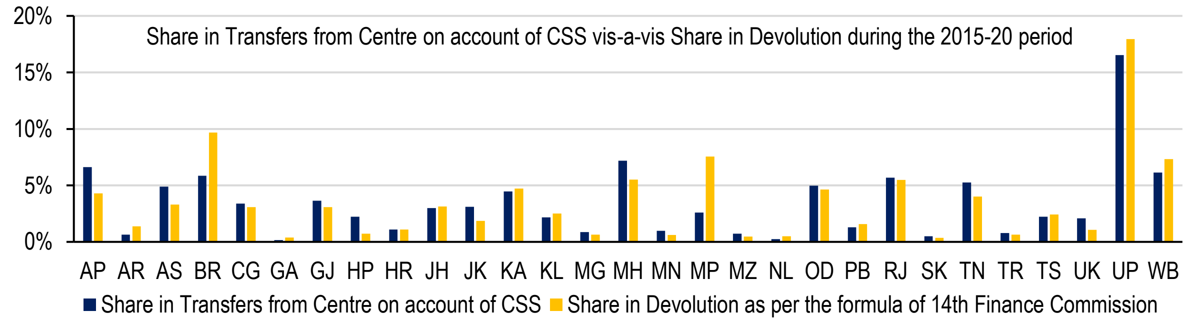


Source: Union Budget Documents of various years; PRS.

A key concern with the centrally sponsored schemes has been that they often delve into subjects which form part of the State List under the Constitution.[25] For example, the National Health Mission and Ayushman Bharat scheme deal with Health, which is a State Subject. This raises the question of whether the central government should sponsor such schemes, or instead devolve untied funds to the state governments. One of the arguments for the continuance of CSS has been that these may ensure the availability of certain benefits to all citizens of the country at a uniform level.[26] These schemes enable the Centre to take certain policy measures as national development priorities.[26]

The 15th Finance Commission cited studies which show that purpose-specific transfers such as CSS deviate from the emphasis on higher transfers to poorer states for equity, as seen in transfers governed by the Finance Commission recommendations.[25,27] It observed that states with higher per capita income are able to take better advantage of these schemes.[25] CSS schemes have multiple conditionalities attached.[25] This results in a disadvantage for poorer states as they have lower institutional and fiscal capacity to meet these conditions.[25] The Commission had observed that many of these schemes are input or process based. It had recommended that such schemes should move in the direction of equal per capita transfers, with output-based conditions.[25]

Figure 13: Poorer states have a lower share in CSS grants, in comparison to the share in devolution



Sources: State and Union Budget Documents of various years, RBI; PRS.

Expert bodies have pointed out that the number of centrally sponsored schemes is high, and there is a need to rationalise them to bring the number down.[25,26,28] Such rationalisation is carried out periodically. However, the number tends to increase again.[28] As per the Union Budget 2022-23, such a rationalisation for the 15th Finance Commission period (2020-26) was carried out, and led to a reduction in the number of CSS from 130 to 65.[29] However, the overall budget allocation has stayed at a similar proportion of the total transfer (Figure 12). This may be due to: (i) some rationalisation involving only clubbing of multiple schemes into one, (ii) 87% of allocation in 2022-23 is towards 15 flagship schemes which would continue in more or less similar form as earlier.[30] Since then, new schemes have been announced, which would further increase the number of CSS (Annexure IV).

Developments in the power distribution sector pose risks to state finances

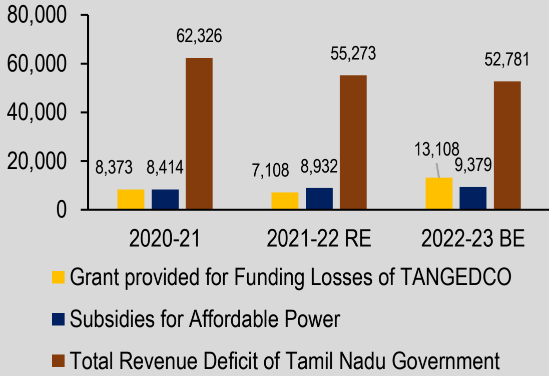
Power distribution in most states is through either state-owned distribution companies (discom) or power departments. These power utilities have continued to make losses (Rs 2.9 lakh crore between 2017-18 and 2020-21), which has required state governments to provide various types of support. The liabilities of these discoms are contingent liabilities of the state government, and the burden of its servicing will fall on the state government if the discom itself is unable to. Thus, poor financial situation of discoms may pose risks to the finances of state governments. The extent of these transactions can be best understood from the example of TANGEDCO (see box below), the discom of Tamil Nadu, which has been among the highest loss-making distribution utilities in the country.[31]

Case Study: Losses of TANGEDCO and its impact on Tamil Nadu Finances

Under the UDAY scheme, the state government had taken over the debt of TANGEDCO worth Rs 22,815 crore between 2015-16 and 2016-17.[32] This was to facilitate its financial turnaround. The outstanding debt of Tamil Nadu is estimated to be 26.3% of GSDP at the end of 2022-23, with UDAY-related liabilities at 1% of GSDP.

Despite the above intervention, TANGEDCO accumulated losses worth Rs 48,491 crore between 2016-17 and 2020-21.[33] In 2021, TANGEDCO took market loans worth Rs 30,230 crore, with guarantee from Tamil Nadu government to clear its dues to generators and transmission companies (1.2% of 2022-23 GSDP).[34] The total outstanding guarantee of Tamil Nadu government was estimated at 4.8% of GSDP as of 2020-21. The state government is estimated to provide Rs 28,589 crore between 2020-21 and 2022-23 as grants to compensate losses of TANGEDCO. Without this grant, the state's revenue deficit in 2022-23 would have been about 25% lower. The state government has also provided loans worth Rs 1,984 crore during this period from the budget.

Figure 14: Key budget outlays for the power sector in Tamil Nadu (in Rs crore)

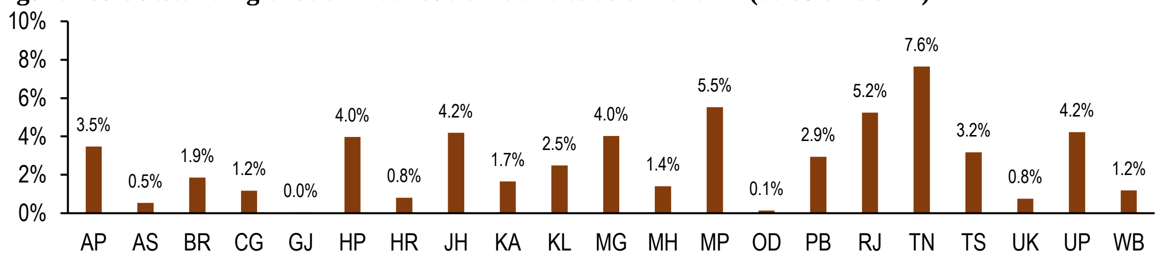


Sources: Tamil Nadu Budget 2022-23; PRS.

The White Paper released by Tamil Nadu government highlighted the following as key reasons for persistent losses: (i) underpricing of tariffs (tariffs were not revised for seven years), (ii) technical and commercial losses (14% in 2020-21), (iii) increase in cost of power, and (iv) loss of share in supply to industry consumers due to higher prices for them (from 60% in 2011-12 to 31% in 2020-21).[33]

As of March 2021, the outstanding debt of distribution utilities was Rs 5.86 lakh crore, about 3% of national GDP, with comparatively higher debt in states such as Tamil Nadu and Madhya Pradesh.

Figure 15: Outstanding debt of Distribution Utilities as of 2020-21 (as % of GSDP)



Sources: Power Finance Corporation; PRS.

Subsidised Power: Subsidy for free or affordable power is a key subsidy provided by state governments (see Figure 28) and formed about 20% of the total revenue of distribution utilities in 2020-21. While these subsidies are significant (about 4%-5% of total revenue receipts on aggregate), explicit subsidy alone is not able to cover the requisite gap. Certain high-paying consumers such as industries and commercial consumers also partly cross-subsidise consumption of other consumers. For example, in 2019-20, industrial consumers purchased about 28% of total supply, but their contribution to the total revenue was 34%. Such a structure has multiple repercussions such as: (i) cross-subsidising consumer moving away from local supply either through captive generation, or direct procurement from generators, and (ii) adverse impact on cost competitiveness of the industry. If cross-subsidy levels are to be reduced a higher subsidy expenditure would be required from state budgets to keep prices at the current level.

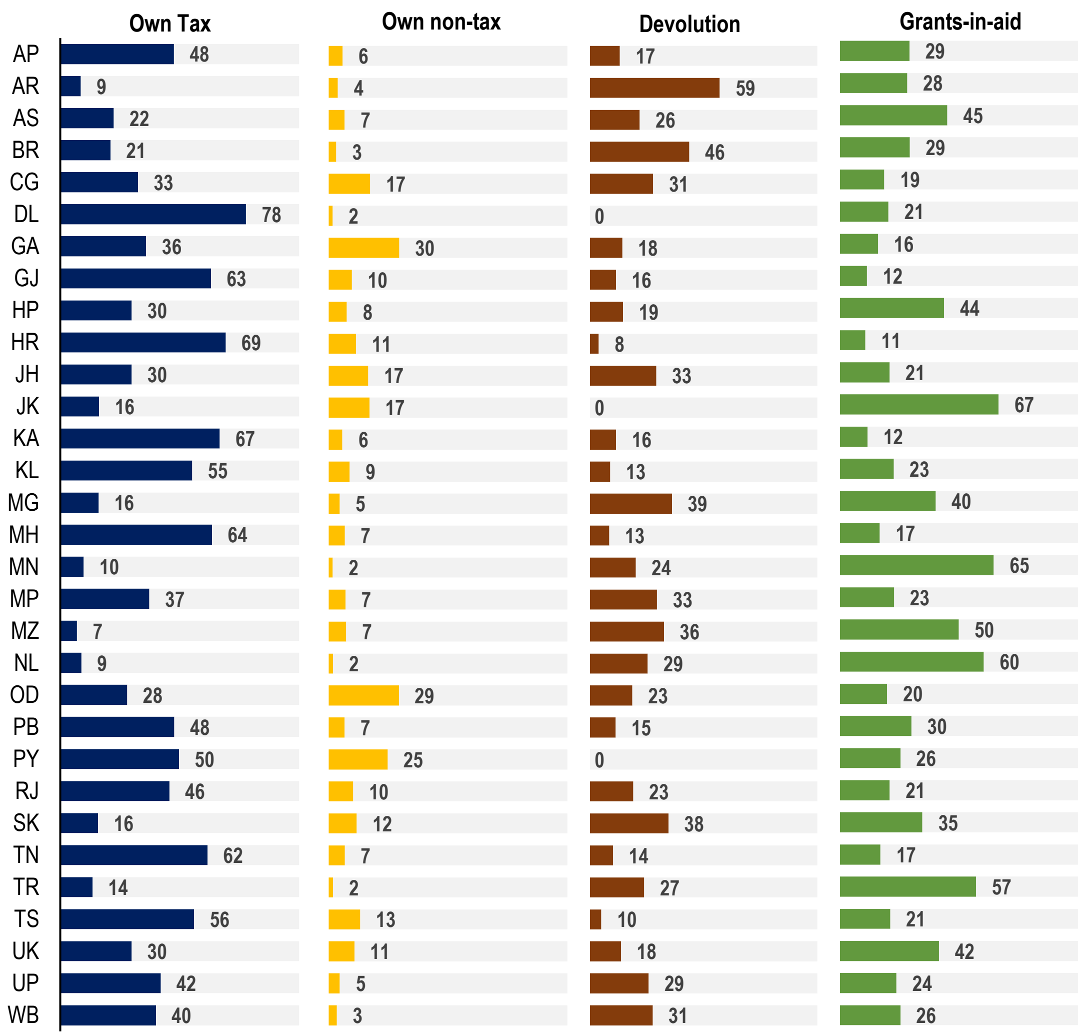
TRENDS IN STATE FINANCES

This section discusses trends in state finances based on the budget estimates for 2022-23.

Significant dependence on central transfers in some states

Revenue receipts of a state can be classified as: (i) own revenue and (ii) transfers from the Centre. Own revenue comprises revenue earned by the state government on its own from tax and non-tax sources. The Constitution provides that states will have a share in the taxes collected by Centre. The Finance Commission determines the criteria for distribution of this share among states. In addition, the central government provides various types of grants to state governments. These include: (i) certain grants as per the recommendations of the Finance Commission such as revenue deficit grants, disaster management grants, and grants to local bodies, (ii) grants for centrally sponsored schemes, and (iii) GST compensation grants. Based on the recommendations of the Finance Commission, the composition of revenue receipts of a state may undergo certain changes every five years. The recommendations of the 15th Finance Commission are applicable during the period between 2021-22 and 2025-26.

Figure 16: Composition of Revenue Receipts (2022-23, figures in %)



Sources: State Budget Documents; PRS.

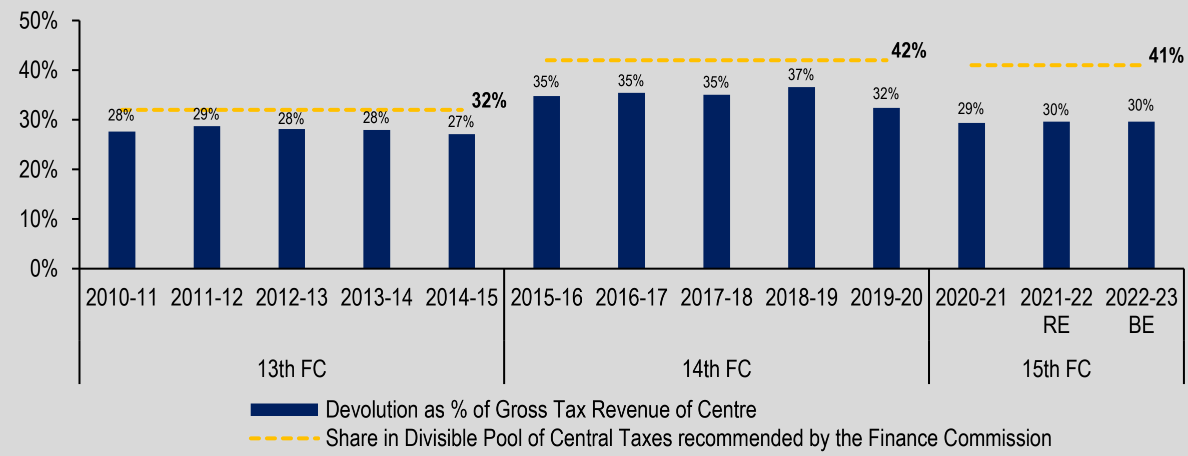
In 2022-23, the states on aggregate are estimated to earn 55% of their revenue receipts from own sources – own tax (46%) and own non-tax (9%). Delhi, Haryana, Karnataka, Gujarat, Maharashtra, and Tamil Nadu expect to earn more than 60% of their revenue from own tax sources. Contribution of non-tax revenue is significantly higher than the average in some states. This could be due to mining royalty and electricity distribution being a departmental function, unlike other states which have discoms (see page 12-13).

Bihar and north-eastern and hill states are most dependent on central transfers for revenue. In the case of Arunachal Pradesh and Bihar, a comparatively higher percentage of central transfers is in the form of devolution of central taxes. Whereas, in the case of other north-eastern states and hill states (Jammu and Kashmir, Himachal Pradesh, and Uttarakhand), the share of grants is higher. The funds from devolution are untied, i.e., states are free to spend it as per their own priorities. Grants may be untied such as revenue deficit and GST compensation grants, or tied to specific priorities and with multiple conditions, as in the case of centrally sponsored schemes and grants for local governments. There may be limited flexibility and choice in expenditure planning in latter cases. Delhi, Jammu & Kashmir, and Puducherry do not have a share in central taxes as they are union territories and grants are allocated from the budget of the Union Home Ministry.

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

For the period between 2021-22 and 2025-26, the 15th Finance Commission has set the share of states in the divisible pool of central taxes at 41%. Divisible pool is arrived at after excluding the cost of tax collection, and cesses and surcharges from the gross tax revenue collected by the central government. Due to an increase in incidence of levy of cesses and surcharges by the central government in recent years, the devolution to states as share of gross tax revenue has seen a notable decline. In 2022-23, states' share in central taxes is estimated to be 30% of the gross tax revenue of the central government.

Figure 17: Devolution as % of Gross Tax Revenue

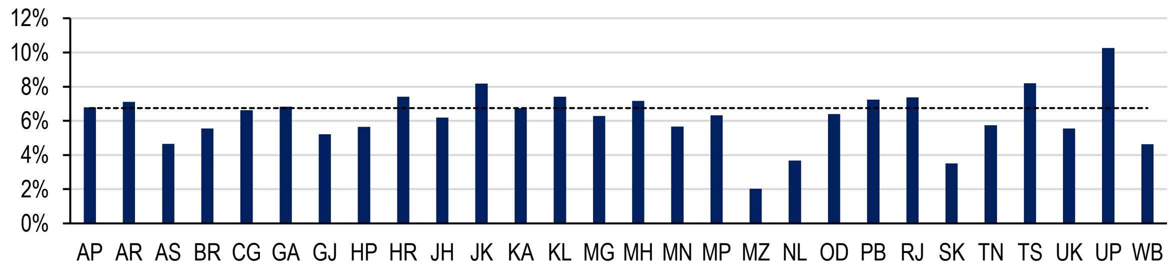


Sources: Union Budget Documents; PRS.

States' own tax revenue estimated to be about 6.7% of their GSDP

In 2022-23, states on aggregate have estimated their own tax revenue at 6.7% of their GSDP. A higher ratio indicates a better ability to harvest taxes from the economic activities in the state. Tax collection depends on a number of factors including income level, structure of the economy, tax rates, and tax administration. Uttar Pradesh has estimated a significantly high own tax revenue (10.3% of GSDP in 2022-23) as compared to the average. In 2019-20 and 2020-21, its own tax to GSDP ratio was 7.2% and 6.2%, respectively.

Figure 18: Own Tax Revenue as % of GSDP (2022-23, as per budget estimates)

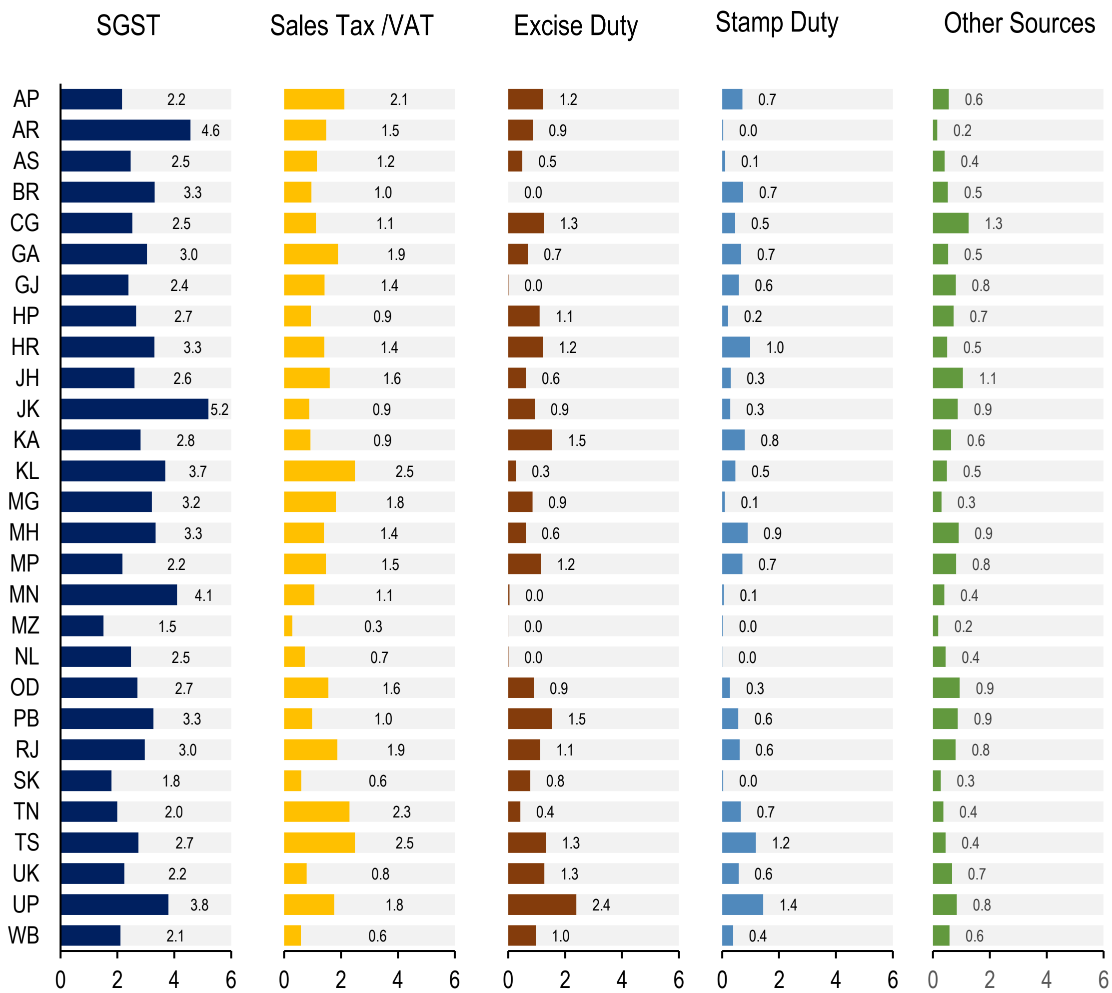


Note: Delhi, Puducherry, and Tripura not shown in above chart, as 2022-23 GSDP estimate is not available for them.
Sources: State budget documents; PRS.

SGST is the largest source of own tax revenue

Key sources of own tax revenue in 2022-23 are: (i) SGST (42% of the total own tax revenue), (ii) sales tax/VAT (23%), (iii) state excise duty (14%), (iv) stamp duty (11%), (v) taxes on vehicles (5%), and (vi) taxes and duties on electricity (3%). With the introduction of GST, the power to make decisions regarding tax rates on a significant portion of own tax revenue of states is delegated to the GST Council. Sales tax/VAT and excise duty mainly come from levies on petroleum products and alcohol. GST legislation envisages bringing petroleum products under the GST regime, on a date recommended by the GST council.[35] If these were to be brought under GST within the current slabs (0%-28%), there may be a substantial revenue loss. As of November 2022, effective tax on petroleum products in Delhi was about 62%.[36] States such as Bihar and Gujarat have nearly zero revenue from excise duty, as these states have enforced alcohol prohibition.

Figure 19: Composition of Own Tax Revenue in 2022-23 (Figures as % of GSDP)

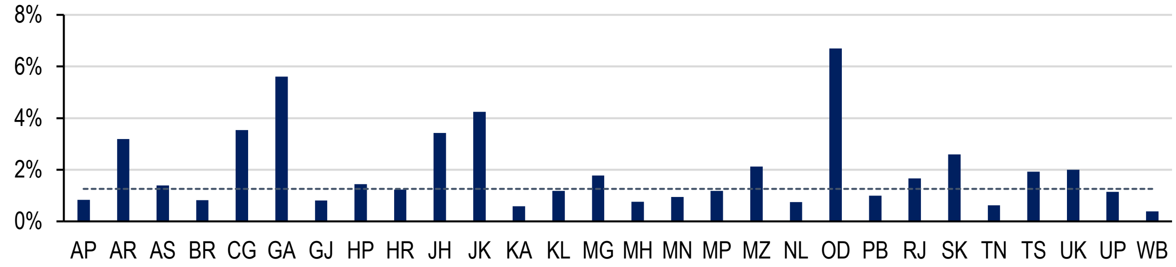


Note: Delhi, Puducherry, and Tripura not shown in above chart as 2022-23 GSDP estimate is not available for them.
Sources: State Budget Documents; PRS.

Own Non-Tax Revenue estimated to be about 1.3% of GSDP

In 2022-23, states on aggregate have estimated their own non-tax revenue to be about 1.3% of their GSDP. There is a wide variation in the level of own non-tax revenue earned across states. States such as Odisha, Chhattisgarh, and Jharkhand have estimated a significantly higher non-tax revenue mainly on account of mining royalty. In case of Odisha, non-tax revenue is estimated to be higher than own tax revenue in both 2021-22 and 2022-23. In states such as Goa, Jammu & Kashmir, Arunachal Pradesh, Sikkim, and Mizoram, as electricity distribution is a departmental activity, electricity charges collected from consumers are a part of government revenue. In most other states, electricity distribution is undertaken by discoms.

Figure 20: Own Non-Tax Revenue as % of GSDP (2022-23, as per budget estimates)

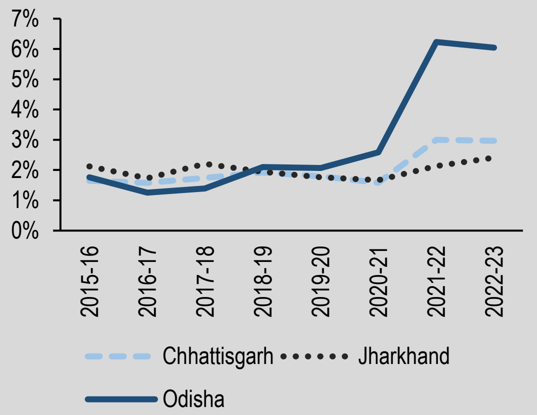


Note: Delhi, Puducherry, and Tripura not shown in above chart as 2022-23 GSDP estimate is not available for them.
Sources: State Budget Documents; PRS.

Revenue from Mining and Metallurgical Industries

Revenue earned from mining and metallurgical industries is an important source of non-tax revenue for states rich in mineral ores. States such as Chhattisgarh, Jharkhand, and Odisha have earned over 60% of their non-tax revenue from mining and metallurgical industries since 2015-16. This includes mining royalty and premium paid by mines.[37] There has been a significant increase in revenue from mining and metallurgical industries in Chhattisgarh, Jharkhand, and Odisha. Odisha has estimated a jump of 190% in revenue earned from mining in the state in 2021-22 compared to 2020-21. The state estimates the increase in mining royalty to materialise from renewal of existing mining leases and online auctioning of mines.[37] Certain mines, especially iron ore mines, were auctioned with a premium of 150%.[37] In addition, the state will also receive royalty payments. In 2021-22 and 2022-23, revenue earned from mining is estimated to be 6.2% and 6% of Odisha's GSDP respectively. In 2022-23, Chhattisgarh has estimated its revenue from mining at 3% of GSDP, while Jharkhand has pegged it at 2.4% of GSDP.

Figure 21: Revenue from mining (% of GSDP)

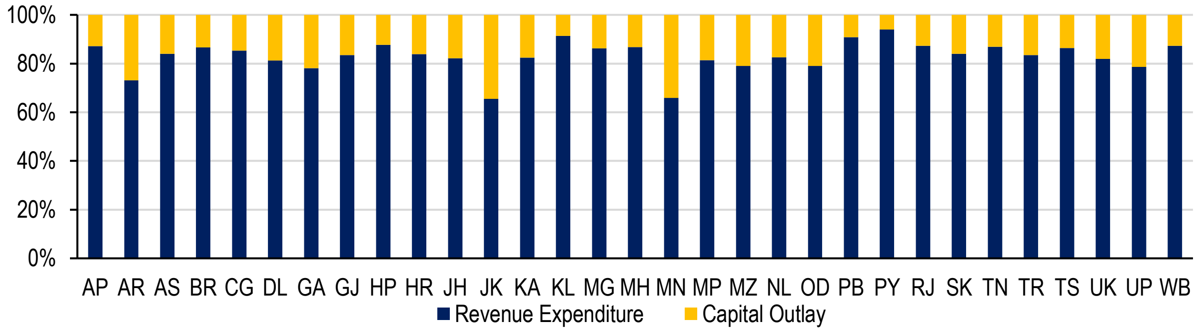


Sources: State Budget Documents; PRS.

Bulk of the expenditure is towards revenue expenditure items

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. It also includes repayment of loans (which lowers the state's liabilities), and loans and advances given by a government. In 2022-23, states on aggregate are estimated to incur 84% of their expenditure as revenue expenditure and 16% as capital outlay (debt components excluded from the expenditure for analysis).

Figure 22: Composition of Expenditure in 2022-23

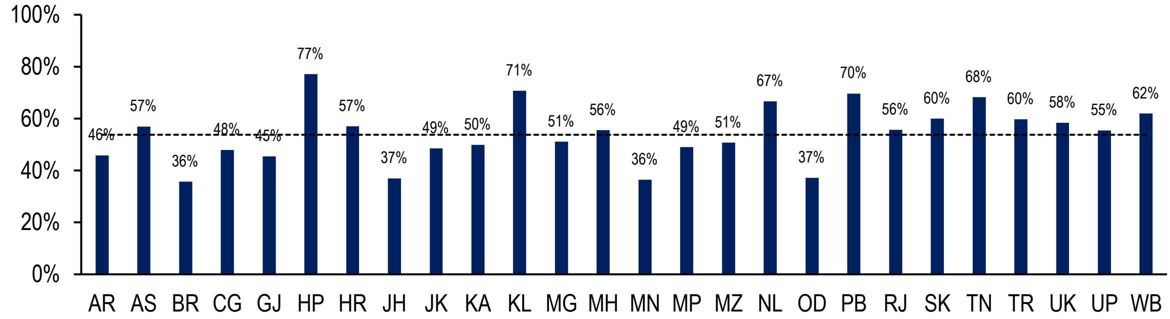


Sources: State Budget Documents; PRS.

54% of revenue receipts to be spent towards three items---interest, pension, and salaries

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. In 2022-23, states on an aggregate have budgeted to spend 54% of their revenue receipts: 29% on salaries and wages, 13% on pension and 12% on interest payments. Spending of states such as Bihar and Jharkhand on committed expenditure is lower than the average. This is mainly due to a lower portion of their revenue receipts being spent on salaries and wages.

Figure 23: Committed expenditure as a percentage of revenue receipts in 2022-23

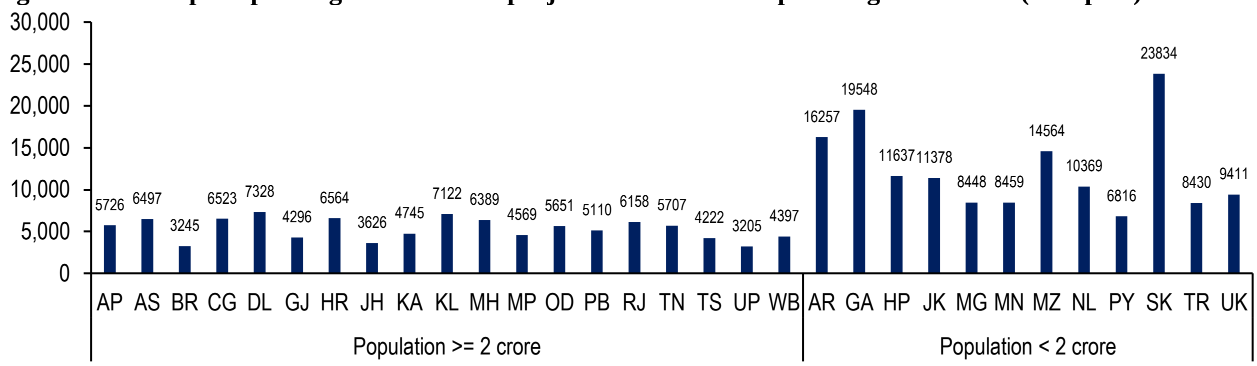


Note: Salary estimates for 2022-23 not provided in the budget documents by states not in the chart.
Sources: State Budget Documents; PRS.

Poorer states continue to lag in spending on education and health in per capita terms

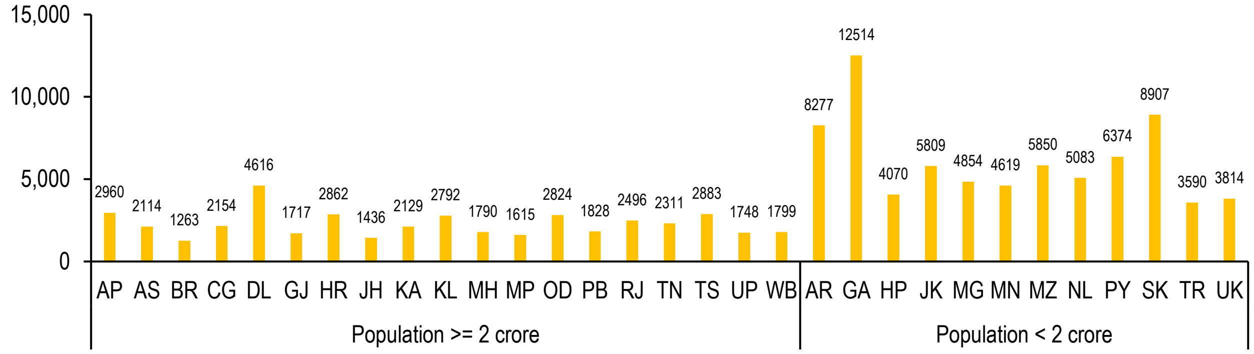
The 15th Finance Commission had observed that states such as Bihar, Jharkhand, and Uttar Pradesh are lagging behind on key human development parameters related to health and education.[38] It also observed that their per capita spending in these areas remain below average, and that there is a need to increase expenditure in these areas for convergence on these parameters. As per the budget estimates for 2022-23, this gap remains significant. For instance, in 2022-23, Bihar has estimated to spend about Rs 3,200 per capita on education and about Rs 1,300 per capita on health. This is significantly lower than the average for larger states, about Rs 5,300 per capita on education, and about Rs 2,300 per capita on health. The per capita expenditure remains low despite Bihar allocating 18.4% of its budget towards education, among the highest in the country. This may be due to lower income levels leading to lower revenue and expenditure capacity. A similar trend can be observed in case of Uttar Pradesh and Jharkhand.

Figure 24: Per capita spending on Education projected in 2022-23 as per budget estimates (in rupees)



Sources: State Budget Documents, National Commission on Population; PRS.

Figure 25: Per capita spending on Health projected in 2022-23 as per budget estimates (in rupees)

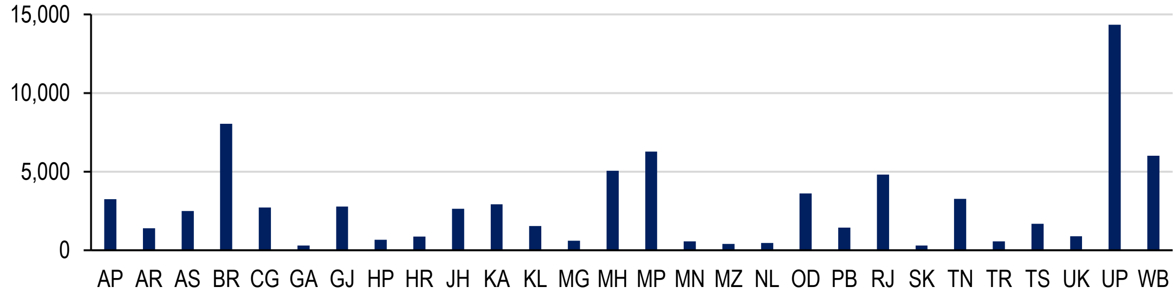


Sources: State Budget Documents, National Commission on Population; PRS.

Interest free loans for capital outlay

Since 2020-21, the central government has been providing financial assistance to states for capital expenditure in the form of 50-year interest free loans.[39] In 2020-21, states received loans worth Rs 11,830 crore for capital expenditure. For 2021-22, this amount was increased to Rs 15,000 crore.[40] In 2022-23, the central government has allocated one lakh crore rupees towards this assistance. This has been divided into seven parts. Under the first part of the scheme, Rs 80,000 crore will be allocated to the states in proportion to their share of devolution of taxes, as recommended by the 15th Finance Commission (Figure 26). The remaining part of the central assistance is earmarked for certain schemes. These include: (i) Rs 5,000 crore for PM Gati Shakti related expenditure, (ii) Rs 4,000 crore for funding of PM Gram Sadak Yojana, (iii) Rs 2,000 crore as incentives for digitisation, (iv) Rs 3,000 crore for projects on optical fibre cable, and (v) Rs 6,000 crore for urban reforms.[39] States will be eligible to get an additional amount of Rs 5,000 crore for undertaking disinvestment of state public sector enterprises and asset monetisation. Funds provided under the scheme can be used by states for new or ongoing capital projects. The loans provided will not be part of the borrowing ceiling of the states and must be spent in 2022-23 itself.

Figure 26: States' share in allocation of central assistance for capital outlay in 2022-23 (Rs crore)

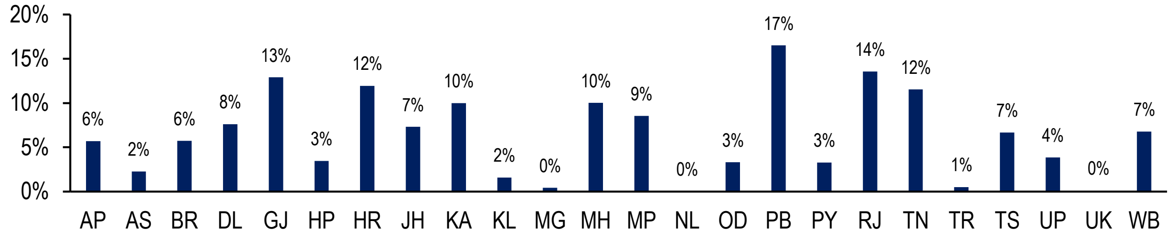


Sources: Ministry of Finance; PRS.

States spent about 8% of their revenue receipts on subsidy in 2019-20

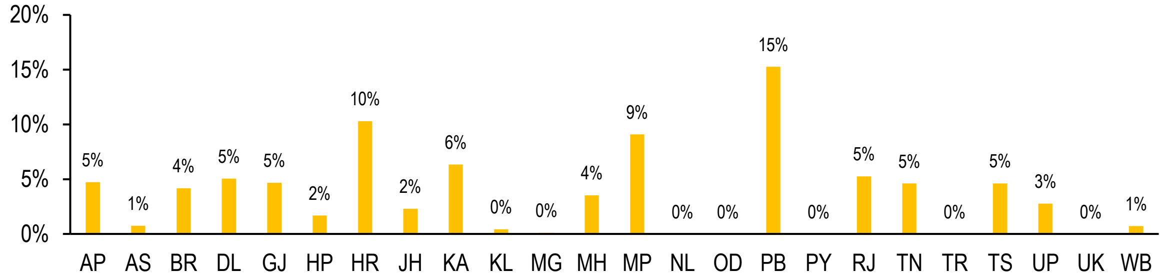
According to CAG's audit reports, states on aggregate spent about 8% of their revenue receipts on subsidy in 2019-20. This spending on subsidy was significantly higher in states such as Punjab (17% of revenue receipts) and Rajasthan (14%). On aggregate, about 55% of total subsidy in 2019-20 was incurred towards free or affordable power. In Haryana, Madhya Pradesh, and Punjab, power subsidy constituted more than 75% of the total subsidy incurred (Figure 27 and Figure 28).

Figure 27: Subsidy incurred as % of Revenue Receipts in 2019-20



Note: Subsidy data not available for states not shown in the chart.
Sources: State Finance Audit Reports, CAG; State Budget Documents; PRS.

Figure 28: Power Subsidy incurred as % of Revenue Receipts in 2019-20



Sources: Report on Performance of Power Utilities for 2020-21, Power Finance Corporation; CAG; State Budget Documents; PRS.

Rush of Expenditure

According to the General Financial Rules, 2017, issued by the Ministry of Finance, rush of expenditure in the closing months of a financial year shall be regarded as a breach of propriety.[41] The Rules suggest that such a situation should be avoided. Various states also have similar provisions in their respective budget manuals. For instance, the Assam Budget Manual considers the rush of expenditure in the closing months of a financial year as a breach of financial regularity.[42] Additionally, the standing orders of the Finance Department of Assam stipulate that a certain percentage of the annual budget should be spent in each quarter for effective budget execution. However, according to observations made by the CAG, several states have been in breach of norms related to rush of expenditure. In Assam's case, the state spent 73% of the annual budget with respect to seven grants in March 2021.[42] In 2019-20, Assam incurred more than 50% of the total expenditure for eight grants in March 2020.[43] In another example, Madhya Pradesh incurred its entire expenditure related to 15 grants in March 2021.[44]

The uneven pace of expenditure by states through the financial year may also be impacted by the pattern of receipts. In 2020-21, the CAG noted a sudden rise in devolution of central taxes received and borrowings done by Madhya Pradesh in March.[44] According to the CAG, substantial expenditure incurred at the end of the financial year indicates inadequate control over expenditure and budgetary management.[44] The CAG has recommended that states may strengthen their financial monitoring and devise suitable mechanisms to avoid rush of expenditure at the end of the financial year.[45] It recommended states to issue guidelines for maintaining a uniform pace of expenditure throughout the financial year where such guidelines are not specified in their budget manuals.[46]

12 states have estimated a revenue deficit in 2022-23

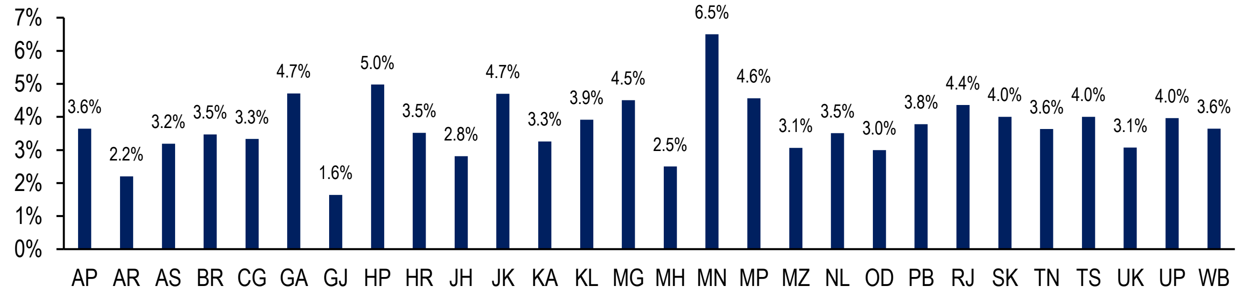
Revenue deficit implies that borrowings are needed to fund revenue expenditure which do not lead to creation of asset or reduction of liabilities. In 2022-23 (as discussed on page 2), 12 states have estimated to incur a revenue deficit at the budget stage. A long-standing recommendation of successive Finance Commissions has been that states should eliminate revenue deficit. Fiscal Responsibility and Budget Management Acts of various states also require states to eliminate revenue deficit. Eight states observed a revenue deficit in all years between 2015-16 and 2019-20. These are: Andhra Pradesh, Haryana, Kerala, Punjab, Rajasthan, Tamil Nadu, Uttarakhand, and West Bengal.

Fiscal deficit estimated at 3.4% of GSDP in 2022-23

Fiscal deficit is the excess of government expenditure over its receipts. A higher fiscal deficit indicates a higher borrowing requirement in a financial year. In 2022-23, the aggregate fiscal deficit of states is budgeted to be 3.4% of GSDP. In 2022-23, the fiscal deficit limit has been set at 3.5% of GSDP, as per the recommendation of the 15th Finance Commission. An additional borrowing of 0.5% of GSDP is permitted, if states implement certain power sector reforms. 17 states have estimated their fiscal deficit to be above 3.5% of GSDP in 2022-23. Seven states have estimated their fiscal deficit in

2022-23 to be above 4% of GSDP. These are Goa, Himachal Pradesh, Jammu and Kashmir, Meghalaya, Manipur, Madhya Pradesh, and Rajasthan. Between 2021-22 and 2025-26, if a state borrows lower than the fiscal deficit limit in one year, it can borrow above the limit to that extent in any of the following years. Further, certain loans such as 50-year interest free loan for capital outlay and loan in lieu of GST compensation grants, which is technically borrowing from the central government, are excluded for the calculation of the fiscal deficit limit, as per the notifications of the central government. From 2023-24 onward, the applicable fiscal deficit limit will be 3% of GSDP. Additional borrowing of 0.5% of GSDP linked to power sector reforms will be available for two more years – 2023-24 and 2024-25.

Figure 29: Fiscal deficit in 2022-23 as per budget estimates (% of GSDP)

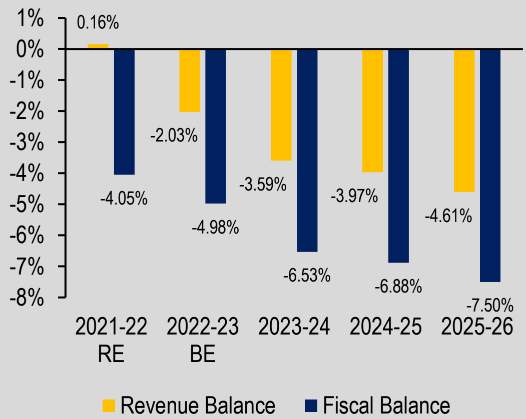


Note: Delhi, Puducherry, and Tripura not shown in above chart as 2022-23 GSDP estimate not available for them.
Sources: State Budget Documents; PRS.

Case Study: Himachal Pradesh's Fiscal Position

The Himachal Pradesh Fiscal Responsibility and Budget Management Act, 2005, requires the state government to keep its fiscal deficit at less than 3% of GSDP and maintain revenue surplus after 2011-12.[47] According to the fiscal roadmap suggested by the 15th Finance Commission, states have to progressively reduce their fiscal deficit to 3% of their respective GSDP by 2023-24. Himachal Pradesh's projected fiscal deficit is estimated to be well above the limits prescribed by the state's FRBM Act and the Finance Commission. In 2025-26, the state's fiscal deficit is projected to be 7.5% of GSDP and revenue deficit at 4.61% of GSDP. According to the state government, its salary and pension expenditure is increasing every year. Fiscal burden due to additional liability from pay/pension revision is seen to be substantial. This may adversely impact spending on assets and capital works. The state also estimates its revenues will be adversely impacted after the discontinuation of GST compensation grants. Himachal Pradesh will receive Rs 37,199 crore as revenue deficit grants between 2021-22 and 2025-26. However, more than half of these grants will be given to the state in 2021-22 and 2022-23, after which its revenue deficit is projected to increase substantially.

Figure 30: Himachal Pradesh's revenue and fiscal balance (% of GSDP)

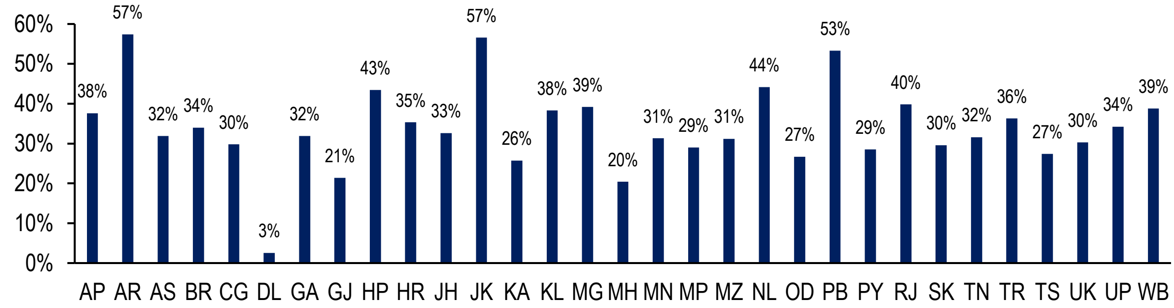


Note: Figures for 2023-24 onwards are projections.
Sources: Himachal Pradesh Budget Documents; PRS.

Outstanding Liabilities of states estimated at 31.2% of GDP as of March 2022

Outstanding liabilities refer to the debt accumulated by states from the borrowings in the past. It also includes certain other liabilities such as liabilities on public accounts. Higher outstanding liabilities 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 were set at 25% of their GSDP. In 2017, the FRBM Review Committee (Chair: Mr. N. K. Singh) recommended a limit of 20% of GDP on aggregate for states.[5] In recent years, outstanding liabilities of states have increased partly due to large one-time expenditure, such as farm loan waivers and debt takeover under the UDAY scheme, and increased dependence on borrowing to fund expenditure since 2019-20. At the end of 2021-22, outstanding liabilities of state governments is estimated at 31.2% of GDP. In the case of 21 states, outstanding liabilities are higher than 30% of GSDP.

Figure 31: Outstanding liabilities as of March 2022 (% of GSDP)

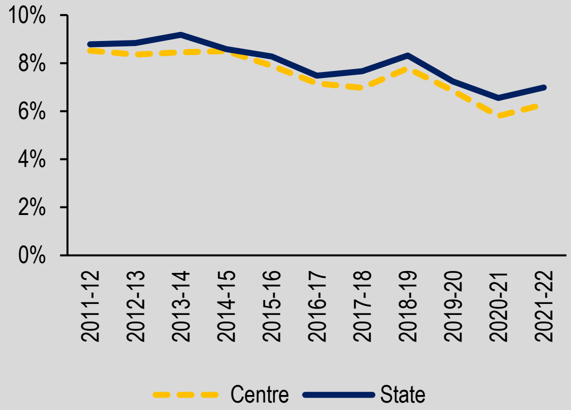


Note: Data is as per budget estimates.
Sources: RBI; PRS.

Yields on State Development Loans

State governments borrow from the market by issuing State Development Loans (SDLs). SDLs are dated securities or bonds wherein interest has to be paid on half-yearly intervals, with the principal repaid on maturity.[48] Over the last decade, the weighted average yield on SDLs has reduced. In 2020-21, the yields on SDLs were the lowest since 2004-05. This was primarily driven by a decrease in repo rate, which reduced from 5.75% in June 2019 to 4% in May 2020. The repo rate was increased to 4.4% only after two years in May 2022. In 2019, the RBI observed that there was no observable relationship between borrowing rates and fiscal health of states.[6] Theoretically, states with relatively better fiscal health should be able to borrow from the market at a lower interest rate. However, RBI observed that states were mobilising funds at similar or near similar yields irrespective of their fiscal position.[6] The Economic Survey (2016-17) had also noted a lack of correlation between yields on SDLs and debt or deficit positions.[49] The Survey noted that states are neither rewarded nor penalised for their debt performance. The RBI recommended a risk-based pricing of SDLs to reinforce self-discipline with respect to fiscal health of states.

Figure 32: Weighted average yield on SDLs and central government securities (in percentage)

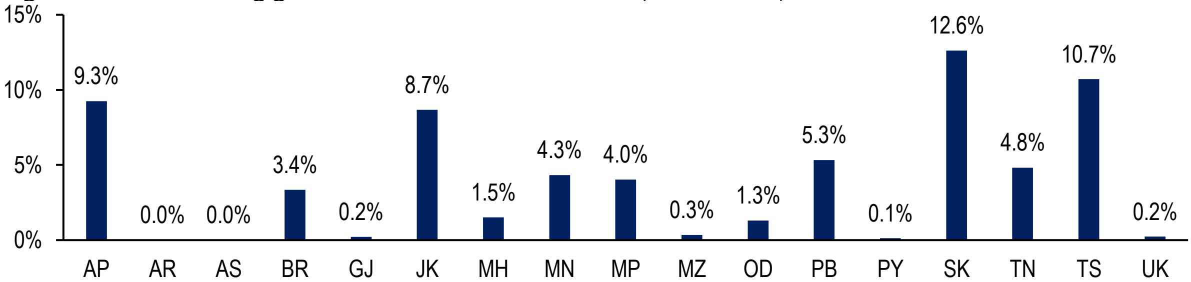


Sources: RBI; PRS.

Outstanding guarantees of state governments

Outstanding liabilities of states do 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 4.2% of their aggregate GSDP at the end of 2020-21 (as per the latest data available for 17 states). Andhra Pradesh, Jammu and Kashmir, Telangana, Sikkim, and Punjab had a comparatively higher guarantee level.

Figure 33: Outstanding guarantee at the end of 2020-21 (% of GSDP)



Note: Data not available for states not shown in the chart. Data is as per revised estimates.
Sources: RBI; PRS.

Off Budget Borrowings

Off-budget borrowings involve the mobilisation of resources needed to finance the expenditure requirements of a particular year which do not appear in the budget documents of that year.[50] As they do not form a part of the budget documents, they may remain outside the legislative oversight.[50] Such expenditure is financed through borrowings by government owned entities such as public sector enterprises or departmental commercial undertakings. However, the government has to service the debt from its budgetary resources.[50] According to the Fiscal Responsibility and Budget Management Act, 2003, the debt of the central government is defined to include the financial liabilities of entities controlled by the Centre which is to be repaid or serviced from the annual financial statement.[51] The 15th Finance Commission had observed that there is a significant amount of off-budget expenditure that are not included in the calculation of debts and deficits.[2] The Commission was unable to arrive at a tenable number of such liabilities due to absence of any disclosure in the state budget documents.

Audit reports of state finances by CAG have highlighted the extent of off-budget borrowings for certain states. In Andhra Pradesh, the state government has raised off-budget borrowings worth Rs 86,260 crore as on March 31, 2021, through corporations and PSUs.[50] If these borrowings were taken into account, the state's outstanding liabilities to GSDP ratio would increase from 35% of GSDP to 44% as on March 31, 2021.[50] In the case of Telangana, taking into account the state's off-budget borrowings of Rs 97,940 crore, the outstanding liabilities would increase from 28% of GSDP to 38%.[52] Such borrowings by the state government bypass the net borrowing ceiling of the state by routing loans outside the state budget.[50]

The 15th Finance Commission recommended against resorting to off-budget borrowings. It noted that such practices are against the norms of fiscal transparency and adversely impact fiscal sustainability. It observed that these obligations must be cleared in a timely manner. However, the resources to service or repay these obligations should not be mobilised from regular inflow of tax and non-tax revenues.[2] The Commission recommended that governments should mobilise additional resources, including monetisation of assets.

Credibility of budget estimates

The state budget provides three sets of numbers: (i) budget estimates: an estimate for the upcoming financial year, (ii) revised estimates: revision in the budget estimates for the ongoing financial year, and (iii) actuals: the final audited amount for the previous year. The state legislature approves the budget for the coming year based on the budget estimates. The revised estimates may provide a more realistic picture of the government's finances in the ongoing year as they are made with reference to the actual transactions already recorded that year. Actuals may fall short of or exceed budget estimates, and this comparison helps understand the credibility of a proposed budget. The latest year for which actuals are available is 2020-21. However, we have not included 2020-21 in our analysis as it was a non-standard year due to the impact of COVID-19 pandemic.

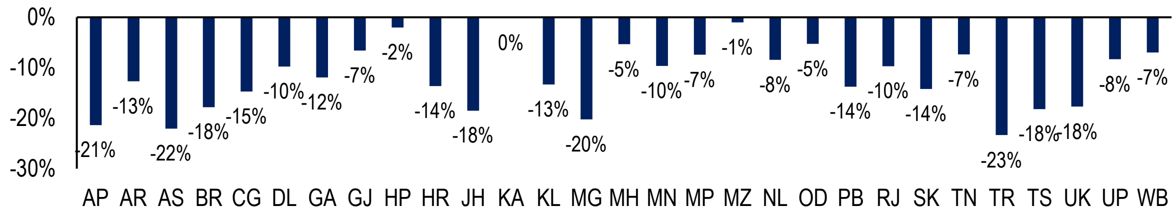
Case Study: Meghalaya's Revised Estimates

Revised estimates presented in the budget documents seek to provide a more realistic picture of the ongoing financial year. They are expected to provide the current assessment of the government's financial position as compared to the beginning of the financial year. However, in Meghalaya, there is hardly any change between budget estimates and revised estimates of a given financial year. Since at least 2015-16, revised estimates have largely remained unchanged from budget estimates. Note that from 2015-16 to 2019-20, Meghalaya's actual revenue receipts and expenditure (excluding debt components) were 20% lower than the budget estimates. Even for 2020-21, when states' revenue was adversely impacted due to the COVID-19 pandemic, Meghalaya's revised estimates were the same as budget estimates.

States raise 10% less revenue than budgeted between 2015-16 and 2019-20

During the five years between 2015-16 and 2019-20, states raised 10% less revenue than their budget estimates. States can borrow more to make up for this shortfall, so that they can spend as budgeted. However, as borrowing is limited by FRBM laws, many states cut their expenditure to meet the borrowing limits (see Figure 35). States such as Tripura (23%), Assam (22%), and Andhra Pradesh (21%) saw a relatively higher shortfall in revenue during this period.

Figure 34: Shortfall in revenue receipts of states between 2015-16 and 2019-20

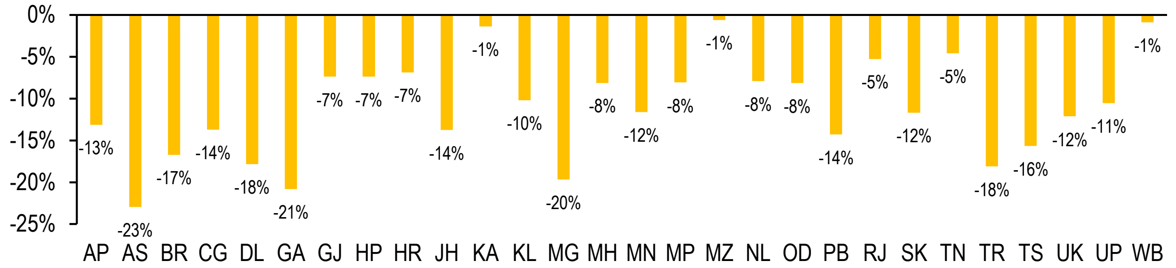


Sources: State Budget Documents; PRS.

States spent 9% less than what they budgeted between 2015-16 and 2019-20

A comparison of the budget estimates with the actual expenditure for five years (between 2015-16 and 2019-20) shows that on average, states underspend their budget by 9%. This underspending can be attributed to a shortfall in revenue collection of states. States such as Assam (23%), Goa (21%), and Meghalaya (20%) saw higher underspending during this period compared to other states. States such as Karnataka and West Bengal have seen the least variance in the budget and actual figures.

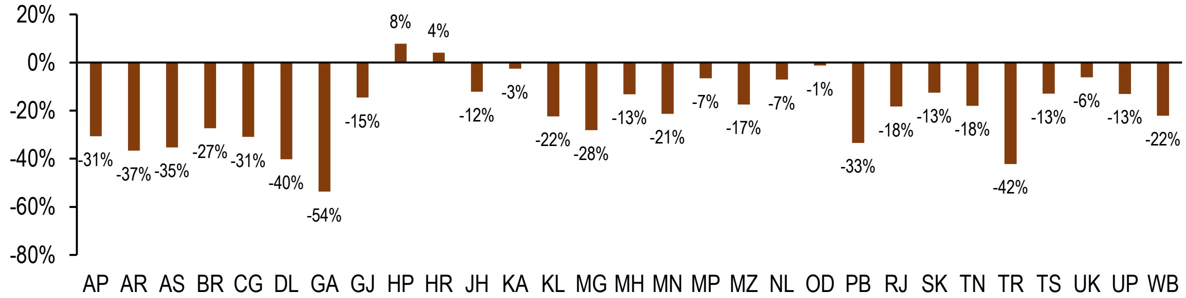
Figure 35: Underspending by states between 2015-16 and 2019-20



Note: Expenditure denotes the sum of revenue expenditure and capital outlay.
Sources: State Budget Documents; PRS.

Average underspending during this period in case of revenue expenditure is 8%. As a large part of revenue expenditure is committed in nature, hence, there is a disproportionately higher underspending in case of capital outlay, at 17%. States such as Goa (54%) and Tripura (42%) saw a much higher cutback in capital outlay compared to the budgeted estimates during this period (Figure 36).

Figure 36: Underspending in capital outlay between 2015-16 and 2019-20

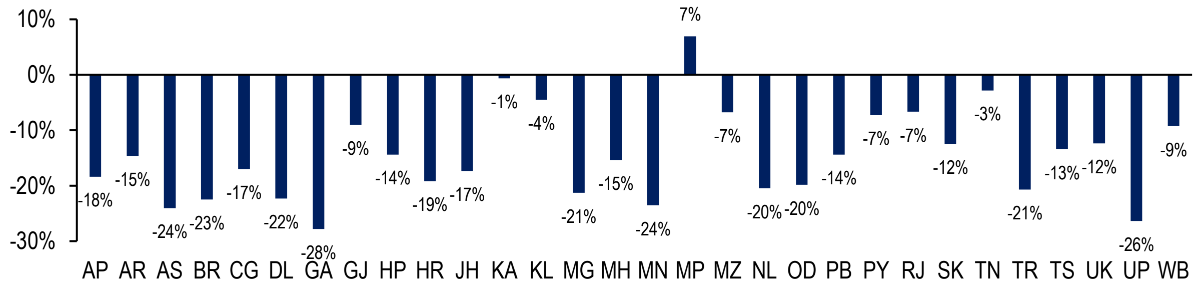


Sources: State Budget Documents; PRS.

In 2020-21, actual spending by states was 14% lower than their budget estimates

In 2020-21, states underspent their budget by 14%, much higher than the average (9%). This could be due to the impact of the COVID-19 pandemic on the ability to earn revenue as well as constraints in executing projects and implementing schemes. In 2020-21, revenue receipts of states on aggregate were 22% lower than the budget estimate.

Figure 37: Underspending by states in 2020-21



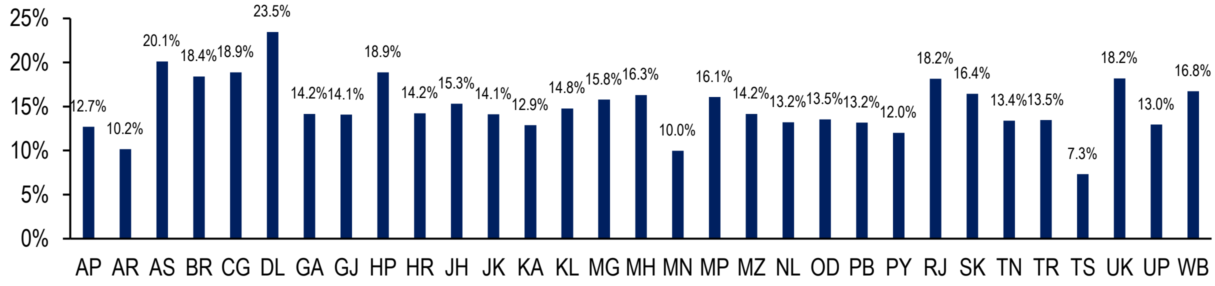
Sources: State Budget Documents; PRS.

Sector-wise outlay in 2022-23

We showcase below the allocation by states on key sectors as per the budget estimates of 2022-23. 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 and the capital outlay 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. States may allocate similar items across different heads. For instance, Andhra Pradesh and Telangana classify spending on schools for SC/ST as welfare expenditure for these sections and not under education; Punjab counts electricity subsidy to farmers under spending for agriculture and not energy. The sectors shown below account for 67% of the total expenditure by states in 2022-23.

Education

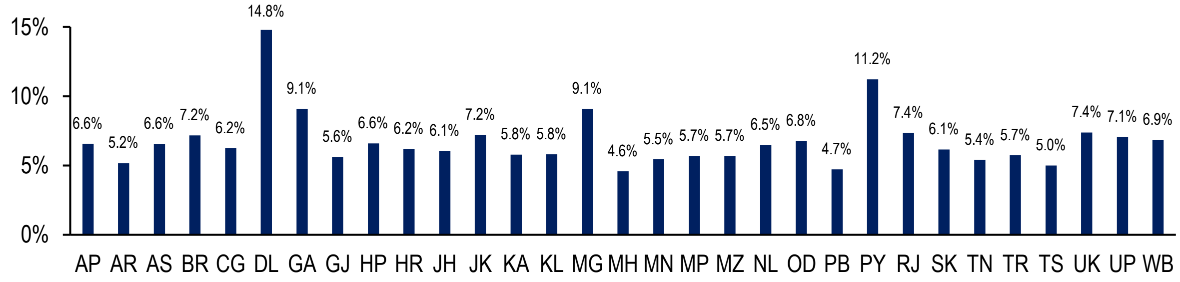
Figure 38: States are estimated to spend 14.8% of their budget towards education



Sources: State Budget Documents; PRS.

Health and family welfare

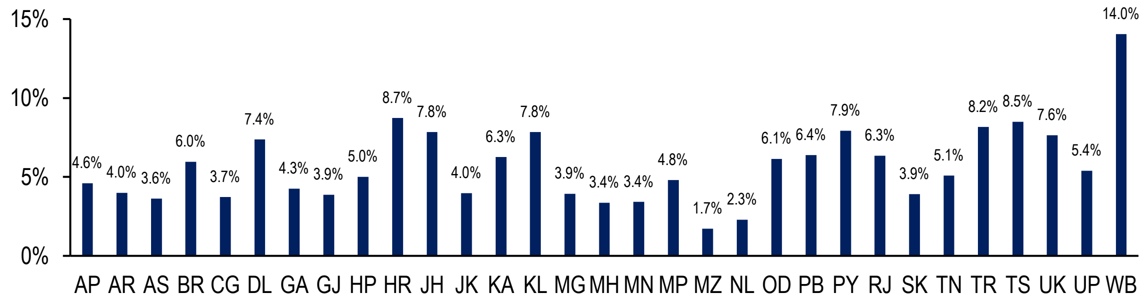
Figure 39: States have allocated 6.3% of their budget towards health



Sources: State Budget Documents; PRS.

Social welfare and nutrition

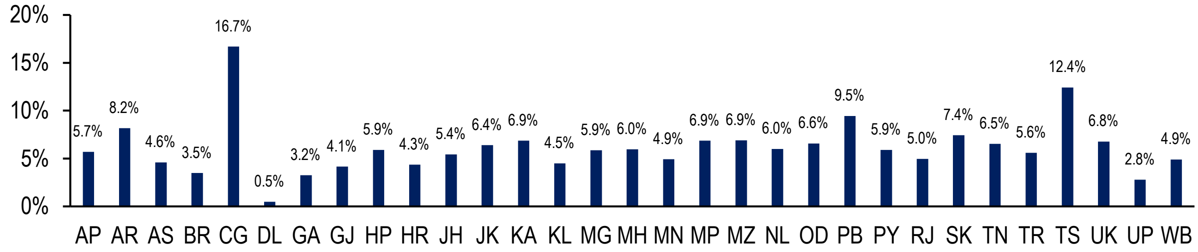
Figure 40: States have allocated 6% of their budget towards social welfare and nutrition



Sources: State Budget Documents; PRS.

Agriculture and allied activities

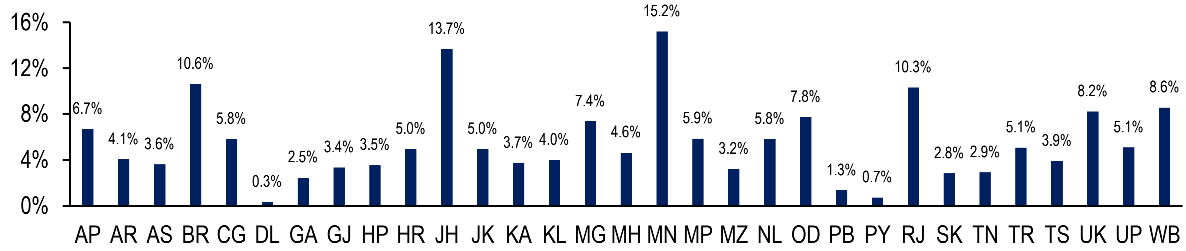
Figure 41: States are estimated to spend 5.8% of their budget on agriculture



Sources: State Budget Documents; PRS.

Rural development

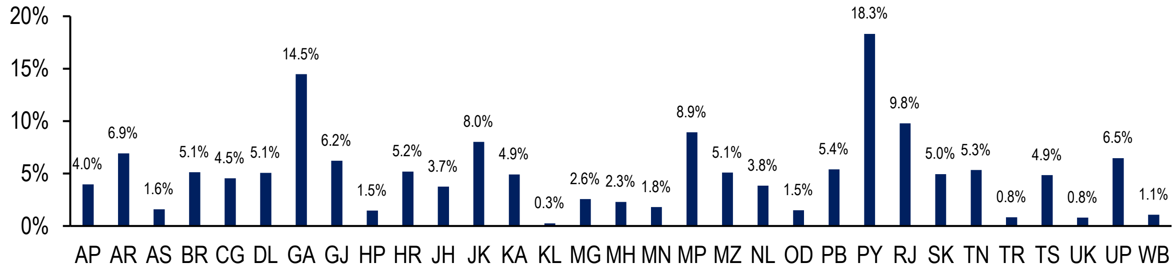
Figure 42: States are estimated to spend 5.7% of their budget on rural development



Sources: State Budget Documents; PRS.

Energy

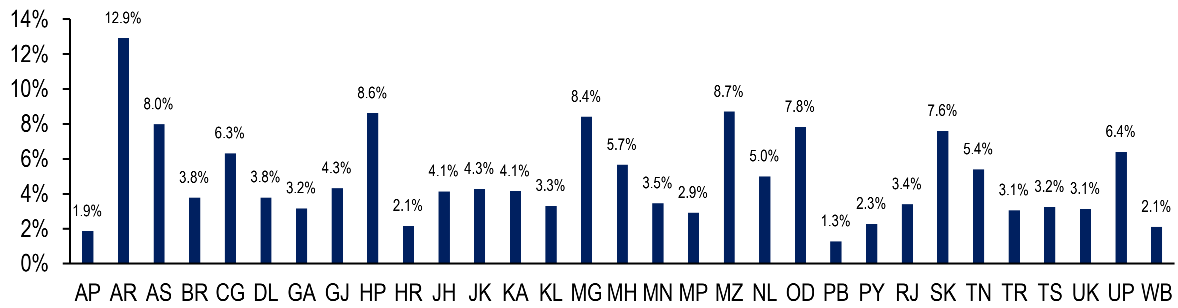
Figure 43: States have allocated 4.8% of their budget towards energy



Note: States such as Puducherry, Goa, and Jammu and Kashmir have higher spending on energy as power distribution is undertaken by the government department unlike state-owned discoms in most other states.
Sources: State Budget Documents; PRS.

Roads and bridges

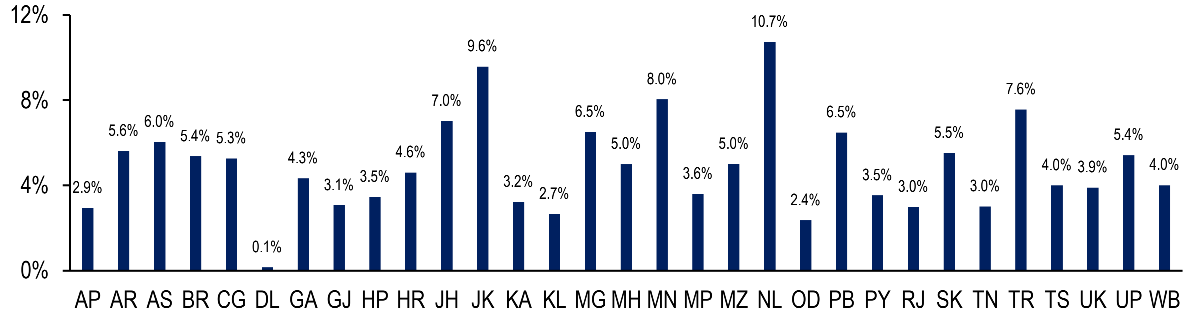
Figure 44: States have allocated 4.5% of their budget towards roads and bridges



Sources: State Budget Documents; PRS.

Police

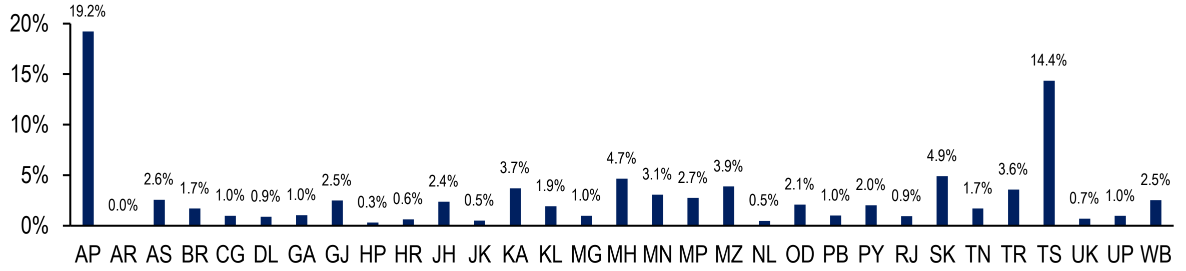
Figure 45: States have estimated to spend 4.3% of their budget towards police



Sources: State Budget Documents; PRS.

Welfare of SC, ST, OBC, and minorities

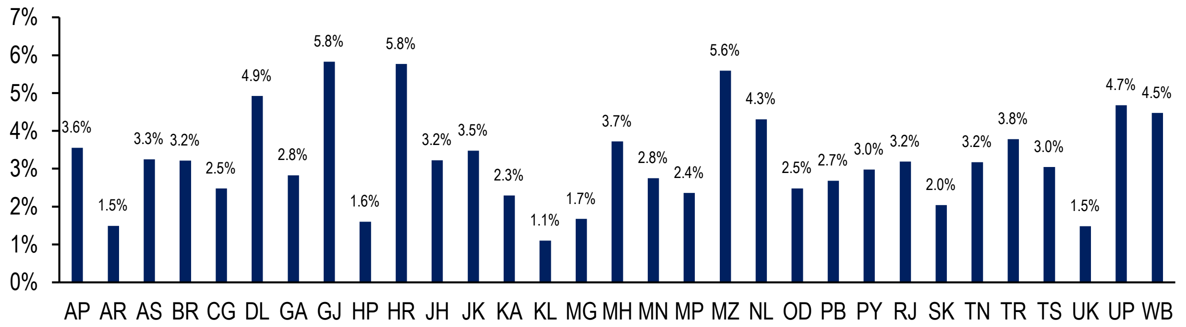
Figure 46: 3.5% of budget allocated towards welfare of SC, ST, OBC, and minorities on aggregate



Sources: State Budget Documents; PRS.

Urban development

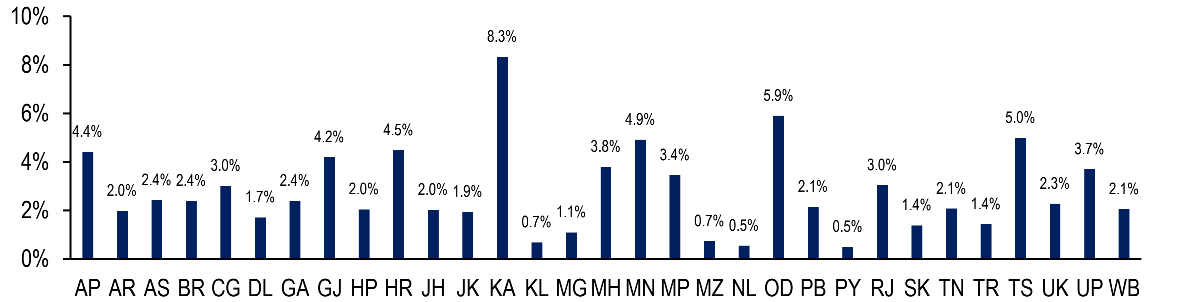
Figure 47: State have estimated to spend 3.5% of their budget towards urban development



Sources: State Budget Documents; PRS.

Irrigation and flood control

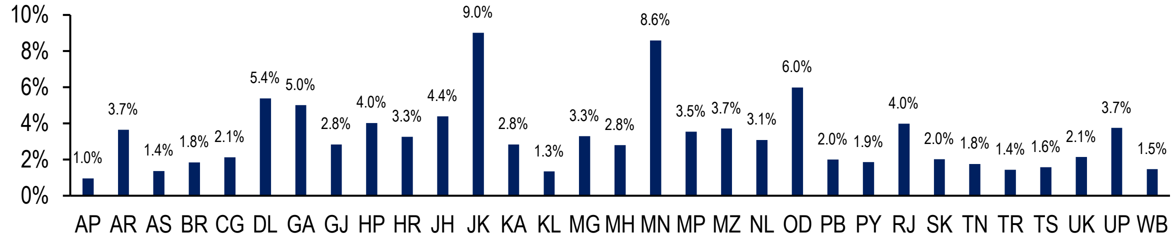
Figure 48: States have estimated to spend 3.5% of their budget on irrigation and flood control



Sources: State Budget Documents; PRS.

Water supply and sanitation

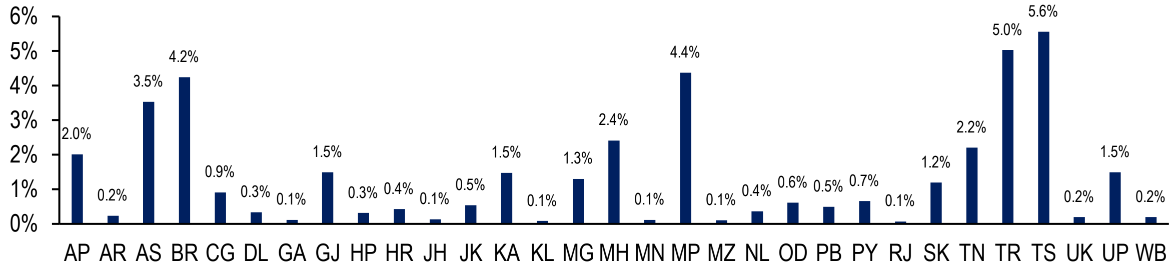
Figure 49: States have estimated to spend 3% of their budget on water supply and sanitation



Sources: State Budget Documents; PRS.

Housing

Figure 50: States have estimated to spend 1.8% of their budget on housing



Sources: State Budget Documents; PRS.

Annexure I: Revenue Deficit Grants during the 2021-26 period

Table 1: Post-Devolution Revenue Deficit Grants recommended by the 15th Finance Commission (in Rs crore)

State	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Andhra Pradesh	17,257	10,549	2,691	0	0	30,497
Assam	6,376	4,890	2,918	0	0	14,184
Haryana	132	0	0	0	0	132
Himachal Pradesh	10,249	9,377	8,058	6,258	3,257	37,199
Karnataka	1,631	0	0	0	0	1,631
Kerala	19,891	13,174	4,749	0	0	37,814
Manipur	2,524	2,310	2,104	1,701	1,157	9,796
Meghalaya	1,279	1,033	715	110	0	3,137
Mizoram	1,790	1,615	1,474	1,079	586	6,544
Nagaland	4,557	4,530	4,447	4,068	3,647	21,249
Punjab	10,081	8,274	5,618	1,995	0	25,968
Rajasthan	9,878	4,862	0	0	0	14,740
Sikkim	678	440	149	0	0	1,267
Tamil Nadu	2,204	0	0	0	0	2,204
Tripura	4,546	4,423	4,174	3,788	2,959	19,890
Uttarakhand	7,772	7,137	6,223	4,916	2,099	28,147
West Bengal	17,607	13,587	8,353	568	0	40,115
Total	**1,18,452**	**86,201**	**51,673**	**24,483**	**13,705**	**2,94,514**

Source: Report of the 15th Finance Commission for 2021-26; PRS.

Annexure II: Implementation challenges with GST

The 15th Finance Commission had observed that improving the efficiency of GST will strengthen finances of central and state governments.[11] This would have a larger impact on state finances as more than 70% of the total GST revenue accrues to the states.[11] Some of the issues and challenges observed with the implementation of GST are discussed below:

Inverted duty structure: The 15th Finance Commission had observed that in case of several goods, the GST rate structure is inverted.[11] This implies that the tax rate on inputs is higher than the tax rate on the finished products. This leads to large refunds through input tax credit and less than expected net tax collections for the general government.[11] The 15th Finance Commission estimated that in 2018-19, about 78.5% of the tax liability on taxable supplies was paid through input tax credits.[11] In its 47th meeting in June 2022, the GST Council recommended rate rationalisation on a number of goods and services to address inverted duty structure.[53] For instance, the GST rate on goods such as printing, writing, or drawing ink, LED lamps, and machines for cleaning, sorting or grading eggs and other agricultural produce was increased from 12% to 18%.[53]

Compliance mechanism under GST: In 2019, the CAG noted that the invoice matching system to validate input tax credit system was not in place even after two years since the roll out of GST.[54] Due to this, the implementation of a non-intrusive tax system remained elusive. In 2022, CAG observed that the originally envisaged non-intrusive e-tax system, based on preventive checks, is yet to be fully implemented.[55] This shortcoming is being addressed through the Department of Revenue's more traditional intrusive functions involving interface between the tax officer and the tax payer.[55] The CAG recommended that the central government may rely more on conducting preventive checks through IT systems, rather than intervention by tax offices to safeguard government revenue.[55]

Supreme Court's ruling on GST Council

In May 2022, the Supreme Court clarified that the recommendations of the GST Council are not binding on the Parliament and state legislatures.[56] The Court reasoned that state legislatures and the Parliament have simultaneous and equal power to make laws on GST as per Article 246A of the Constitution. Making the recommendations of the GST Council binding on the legislature would upset fiscal federalism in India. The Court also observed that Article 279A, which provides for the setting up of the GST Council, does not suggest that the recommendations of the GST Council are binding. The Court held that the recommendations of the GST Council will be binding on the Executive, where it notifies legislation to implement a uniform taxation system.[56]

GST Council recommendations do not automatically become law. State legislatures and the Parliament enact laws to give them force such as through the CGST, SGST and IGST Acts. These laws stipulate that the rule-making power delegated to the central or state governments will be exercised on the recommendations of the GST Council. Till these provisions, as notified under the rules, are in force, the recommendations of the GST Council will be binding on the central and state governments under these laws. However, Parliament and state legislatures could amend these laws. They may choose to delink government action from the recommendations of the GST Council.

Reliability of data maintained by GSTN: While analysing the pan-India data maintained by GSTN, the CAG (2022) observed inconsistencies between the taxable value and declared tax liability.[55] Inconsistencies were also noticed between the CGST and SGST components of GST and between the input tax credit captured in different returns.[55] Due to the significant level of inconsistencies, CAG was unable to ascertain the reliability of the data maintained by GSTN. It recommended the Ministry of Finance to introduce relevant validation controls. Such controls would prevent unreasonable data entries or alert the taxpayer to unreasonable data. This should also be supported by data analytics for important data elements.

Annexure III: Trends in Pension Expenditure

Table 2: Expenditure on pension and retirement benefits across states

State/UT	Amount (in Rs crore)				Annualised Change		
	1992-93	2002-03	2012-13	2022-23	1992-2003	2003-2013	2013-2023
Andhra Pradesh	444	2,364	12,089	17,267	18%	18%	-
Arunachal Pradesh	6	60	331	1,849	25%	19%	19%
Assam	105	776	3,779	11,069	22%	17%	11%
Bihar	243	2,039	8,364	24,252	-	15%	11%
Chhattisgarh	-	391	2,412	7,603	-	20%	12%
Delhi	-	-	0	3	-	-	28%
Goa	11	138	487	2,041	29%	13%	15%
Gujarat	261	1,588	7,198	17,590	20%	16%	9%
Haryana	107	746	3,636	11,201	21%	17%	12%
Himachal Pradesh	62	490	2,747	7,790	23%	19%	11%
Jammu and Kashmir	47	638	3,463	7,519*	30%	18%	14%
Jharkhand	-	750	2,931	8,045	-	15%	11%
Karnataka	349	1,773	7,227	24,016	18%	15%	13%
Kerala	372	2,283	8,867	26,834	20%	15%	12%
Madhya Pradesh	255	1,083	4,947	19,360	-	16%	15%
Maharashtra	368	2,526	11,472	45,512	21%	16%	15%
Manipur	18	167	760	2,351	25%	16%	12%
Meghalaya	9	67	388	1,469	22%	19%	14%
Mizoram	5	47	371	1,726	25%	23%	17%
Nagaland	9	133	677	2,588	30%	18%	14%
Odisha	122	1,030	5,379	18,221	24%	18%	13%
Puducherry	-	-	372	1,112	-	-	12%
Punjab	157	1,356	5,966	15,146	24%	16%	10%
Rajasthan	206	1,683	6,858	24,439	23%	15%	14%
Sikkim	2	29	225	1,120	31%	23%	17%
Tamil Nadu	472	3,327	13,162	39,508	22%	15%	12%
Telangana	-	-	-	11,385	-	-	-
Tripura	22	227	694	3,382	26%	12%	17%
Uttar Pradesh	474	2,751	17,921	77,078	-	21%	16%
Uttarakhand	-	135	1,366	6,703	-	26%	17%
West Bengal	253	2,408	11,036	22,998	25%	16%	8%
Total	**4,379**	**31,005**	**1,45,124**	**4,61,175**	**22%**	**17%**	**12%**

Note: Annualised change is measured as compounded annual growth rate. Figures for Bihar, Madhya Pradesh, and Uttar Pradesh are not comparable to the years before 2002-03 as these states were bifurcated into Jharkhand, Chhattisgarh, and Uttarakhand respectively in 2000. Figures for Andhra Pradesh are not comparable before 2014, as the state was bifurcated for creation of Telangana. *Data for Jammu and Kashmir has been taken up to 2018-19 which was the last full year before the state was bifurcated and its status was changed to UT.
Sources: State Budget Documents; RBI; PRS.

Table 3: Projected spending on pension and retirement benefits of select states (in Rs crore)

State	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
Assam	11,623	12,785	14,063	15,470	17,017			
Bihar	26,435	28,814	31,407	34,234	37,315	40,674	44,334	48,324
Haryana	11,606	12,055	12,550	13,094	13,692	14,350	15,074	15,870
Himachal Pradesh	8,491	9,256	10,089					
Karnataka	26,178	28,534	31,102					
Kerala	30,012	33,413						
Madhya Pradesh	22,644	26,493	30,997	36,267	42,432	49,645	58,085	67,959
Manipur	2,469	2,592	2,722	2,858	3,001	3,151	3,308	2,469
Mizoram	1,829	1,939						
Punjab	15,600	16,068						
Rajasthan	33,064	34,133	38,898	39,115	38,948	39,799	39,302	39,158
Tamil Nadu	39,243	42,382						
Uttar Pradesh	84,786	93,264	1,02,590					
Uttarakhand	7,172	7,674	8,212					

Sources: State Budget Documents; PRS.

Annexure IV: New Centrally Sponsored Schemes launched after April 2020

Table 4: Key new CSS launched after April 2020

Scheme	Goal	Sector	Announced in	Projected Outlay from Union Budget
PM-SHRI	Modernisation of schools	Education	September 2022	Rs 18,128 crore over five years
Computerization of Primary Agricultural Credit Societies (PACS)	Modernisation of PACS societies	Agriculture	June 2022	Rs 1,528 crore over five years
Ayushman Bharat Health Infrastructure Mission	Augmentation of health infrastructure	Health	February 2021	~ Rs 13,000 crore over five years
PM- Matsaya Sampada Yojana	Promotion of fisheries	Fisheries	May 2020	~Rs 9,400 crore over five years
PM Formalisation of Micro food processing Enterprises	Support for setting up or upgradation of food processing industries	Food Processing	June 2020	~ Rs 7,000 crore over five years

Sources: Press Releases of various Ministries, Press Information Bureau; 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 that do not directly impact 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 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 the 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 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 that 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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