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Low capacity to raise taxes makes some states depend on central transfers

States see slow tax growth in recent years; may need GST compensation

Spending priorities have changed a bit after Fourteenth Finance Commission

This report analyses finances of the following 19 states based on their 2017-18 budget documents.

State	Abbreviation	State	Abbreviation	State	Abbreviation
Andhra Pradesh	AP	Jammu and Kashmir	JK	Rajasthan	RJ
Assam	AS	Karnataka	KA	Tamil Nadu	TN
Bihar	BR	Kerala	KL	Telangana	TS
Chhattisgarh	CG	Madhya Pradesh	MP	Uttar Pradesh	UP
Delhi	DL	Maharashtra	MH	West Bengal	WB
Gujarat	GJ	Odisha	OD		
Haryana	HR	Punjab	PB		

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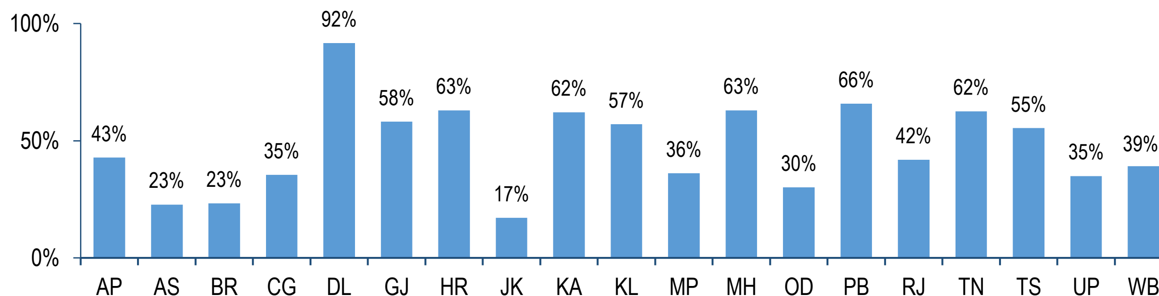
KEY INSIGHTS

Lower capacity to raise taxes makes some states dependent on central transfers

Several states such as Delhi, Punjab, Haryana, Maharashtra, Tamil Nadu and Karnataka raise a majority of their revenue from their own taxes. On the other hand, Jammu and Kashmir, Assam, and Bihar raise around 20% of their revenue from taxes. Consequently, these states have a higher dependency on transfers from the centre, i.e., devolution of central taxes and grants.

Figure 1: Share of tax revenue as a percentage of total revenue varies across different states (2017-18)

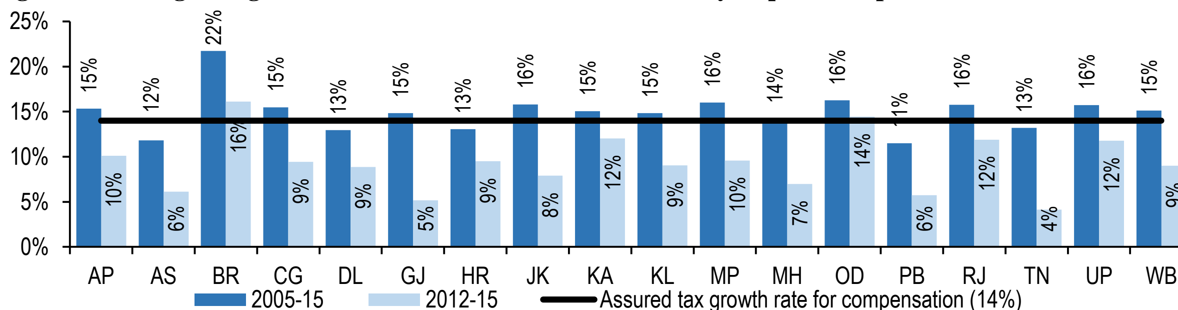


Sources: State Budget Documents; PRS.

States witness slower tax growth in recent years; most may need GST compensation

States which witness tax revenue growth of less than 14% after the implementation of GST, will be compensated by the centre. Tax revenue of states has grown at an annual rate of 9% in the recent years (2012-15), which is much lower than earlier. If this slowdown continues, several states may be eligible for compensation from the centre, as seen in Figure 2 below. Note that this calculation is based on total tax revenue, including sales tax on alcohol which has not been subsumed under GST.

Figure 2: Average tax growth rate indicates that some states may require compensation under GST



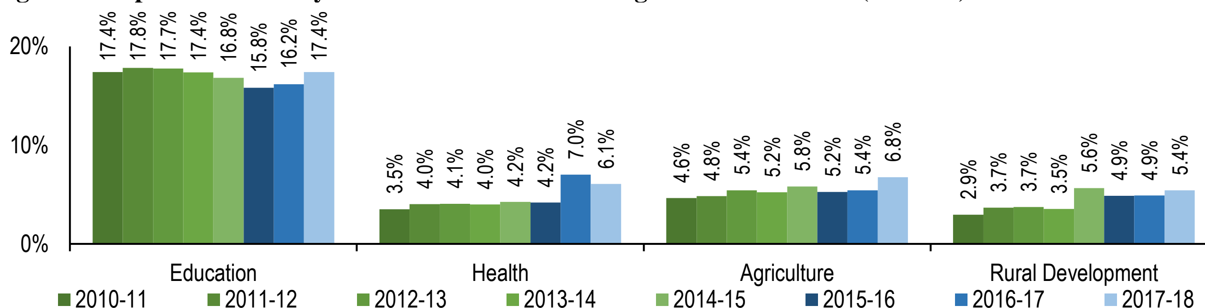
Note: Data for Telangana unavailable.

Sources: State Budget Documents; RBI State of State Finances; PRS.

Spending priorities have changed a bit following the increased devolution of funds

As a result of the 14th Finance Commission recommendations, the centre has devolved a higher share of its taxes (42%) to states. Consequently, the fund sharing pattern for various schemes was revised, given that states had the flexibility to spend on their priorities. In the budgets presented since the increased devolution, expenditure on education has remained range-bound, while that on health has increased.

Figure 3: Expenditure on key sectors as a % of total budget remains similar (2010-17)



Note: Figures for 2016-17 are revised estimates and 2017-18 budget estimates.

Sources: State Budget Documents; RBI State of State Finances; PRS.

In India, while the centre is responsible for subjects such as defence, foreign affairs, and railways, states are responsible for health, education, law and order, and agriculture. Over the last few years, states have been collectively spending more than the central government. For example in 2016-17, states estimated to spend approximately Rs 28 lakh crore. This is 70% more than centre's expenditure which was Rs 16 lakh crore (expenditure of the centre excludes grants given by the central government to the states).

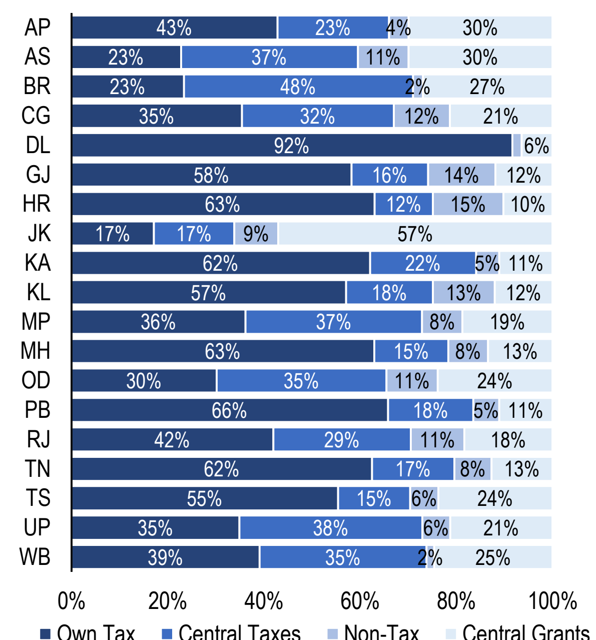
In recent years, finances of states are changing due to: (i) increased devolution of central taxes consequent to the recommendations of the 14th Finance Commission, (ii) introduction of the goods and services tax (GST), and (iii) relaxation in fiscal management limits in some cases, among others. This report analyses the financial position of 19 states (including Delhi) based on their annual budgets across the last few years. It presents a few overarching trends that explain the state of state finances.

GST assures 14% growth in tax revenue; states may lose some flexibility

Own tax revenue is the largest component of revenue for most states

Typically, own tax revenue of states constitutes the largest share in the revenue receipts of states. Prior to the introduction of the goods and services tax (GST), tax revenue included receipts from the levy of: (i) sales tax, (ii) state excise duty, (iii) entry tax on goods and passengers, and (iv) stamp duty, among others. In 2017-18, own tax is estimated to contribute 47% of the total revenue of these 19 states. Note that these estimates were made by states prior to the introduction of GST, which subsumed various indirect taxes, including sales tax (except on alcohol and petroleum), and entry tax (octroi). Sales tax was expected to be the largest component of states' total tax revenue (65%).

Figure 4: Revenue composition of states (2017-18)



Note: Estimations do not take into account the roll-out of GST.
Sources: State Budget Documents; PRS.

In addition, states earn non-tax revenue through various sources, including interest earned on loans provided by states, licensing fee for mineral exploration, fee levied in relation to forestry, among others. Non-tax revenue constitutes 7% of their revenue on an average in 2017-18.

States receive 46% of their revenue from the central government: (i) 26% received as states share in central taxes, and (ii) 20% received as grants-in-aid for schemes and other programmes. As seen in Figure 4, states such as Delhi, Maharashtra, Tamil Nadu, and Karnataka are less dependent on the centre and generate most (over 70%) of their revenue on their own. On the other hand, states such as Assam, Bihar, Odisha, Jammu and Kashmir, and Uttar Pradesh are relatively more dependent on the centre, and raise 40% or less of their total revenue on their own.

States may lose some flexibility; decisions to be made collectively in the GST Council

Prior to the implementation of GST, each state decided the items on which certain taxes (such as sales tax) were to be levied, and at what rate. This meant that an item, such as a washing machine, could be priced differently in different states owing to differences in tax rates. Under the GST framework, both the centre and states have concurrent powers to notify tax rates. These rates will be levied on items at a uniform rate across the country. This means that a washing machine would be levied the same tax rate across the country.

In order to achieve this, the GST Council consisting of union and state finance ministers will decide tax rates for all goods and services. This decision will be taken by a 75% vote (the centre has 33% vote, and each state has an equal vote share in the remaining 67%). This implies that a successful vote will require the centre and 20 out of 31 states (including Delhi and Puducherry) to agree. Once a decision is made, the Council will recommend that the centre and state governments notify these tax rates for the central GST and state GST, respectively.

Tax rates after the implementation of GST

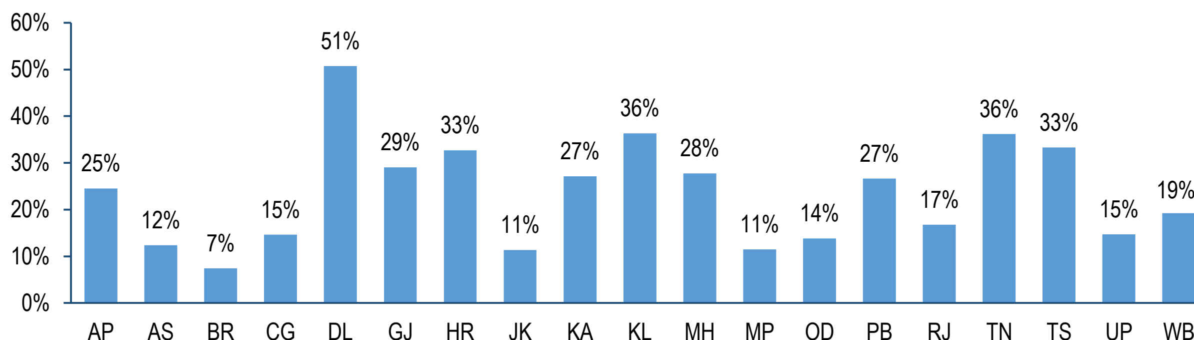
Under GST, all goods or services have been classified under the following tax brackets: (i) 5%, (ii) 12%, (iii) 18%, (iv) 28%, and (v) 28% along with the GST Compensation Cess. In addition, some items have also been classified under the 0% tax bracket (which means that they will be eligible for input tax credit), and some are exempt.

For example, prior to the implementation of GST, sales tax rate on cars varied from state to state. For instance, while in Delhi sale of cars was taxed at a rate of 12.5%, in Tamil Nadu it was taxed at 14.5%.[1] This was in addition to excise duties which were uniform across the country. Under GST, cars will be taxed at 28% across the country (in addition to this, the GST Compensation Cess will also be levied on cars).

Less than 23% of states' total revenue to be subsumed into GST

GST subsumes various taxes levied by states such as sales tax on goods (except alcohol and petroleum), and entertainment tax. Less than 23% of the total revenue receipts of states (includes tax revenue, non-tax revenue, and central transfers to states) are expected to get subsumed under GST. This figure includes sales tax levied on alcohol, which is not subsumed. Therefore, the percentage of tax revenue subsumed under GST will be less than what is shown in Figure 5.

Figure 5: On average, less than 23% of the total revenue of states subsumed under GST (2014-16)

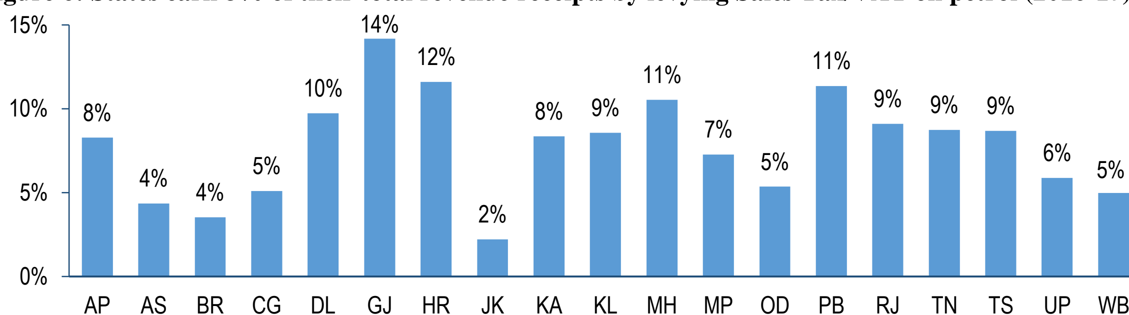


Note: GST does not subsume Sales Tax on alcohol. However, this chart does not exclude such amount as this data is not available for all states. Therefore, the percentage of tax revenue subsumed under GST is less than shown here.
Sources: State Budget Documents; Petroleum Planning and Analysis Cell; RBI State of State Finances; PRS.

Autonomy of states in tax related decisions

Prior to the implementation of GST, states had the autonomy to make decisions regarding the rates and manner in which certain taxes will be levied. With the roll-out of GST, decisions related to some of these taxes will be taken by consensus (or voting) in the GST Council. While states may lose some flexibility in deciding tax rates on goods and services as a consequence of GST, they will continue to have the power to decide the manner in which they will levy certain other indirect taxes. Some of these taxes for which states can continue to decide the rates and the manner of levy include: (i) taxes on land and buildings, (ii) state excise duty on alcohol and narcotics, (iii) taxes on electricity, (iv) sales tax on alcohol and petroleum (till the GST Council decides to bring petroleum under GST), (v) taxes on the transport of goods and passengers, (vi) road tax, and (vii) tolls. For example, on average, states earn 8% of their total revenue receipts by levying sales tax on petroleum products.

Figure 6: States earn 8% of their total revenue receipts by levying Sales Tax/VAT on petrol (2016-17)



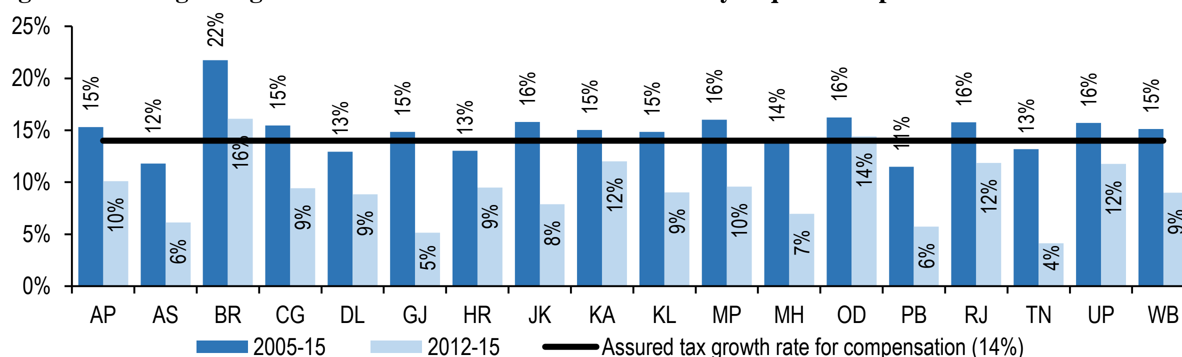
Sources: Petroleum Planning and Analysis Cell, Ministry of Petroleum and Natural Gas; Reserve Bank of India; PRS.

States witness slower tax growth in recent years; most may need compensation

GST subsumes several state indirect taxes such as sales tax levied on goods (other than petroleum products and alcohol), entry tax, and luxury tax. The central government has guaranteed compensation to states in case of any loss in tax revenue collections due to the implementation of GST. To calculate such loss, a state's tax revenue in 2015-16 will be assumed to grow at 14% annually. If any state witnesses annual tax revenue growth of less than 14% after the implementation of GST, the centre will compensate the states for the shortfall. The centre will fund this compensation by levying a GST Compensation Cess on certain items such as motor vehicles and cigarettes.

Over the period between 2005-06 to 2015-16, tax revenue of states grew annually at 15%, on average. However, growth in taxes in the recent years between 2012-15 has been much lower, with tax revenue of states growing at an annual average of 9%. If this growth slowdown continues, several states may be eligible for compensation from the centre. These include Andhra Pradesh, Chhattisgarh, Gujarat, Kerala, Maharashtra, Uttar Pradesh, and West Bengal (see Figure 7). Note that this calculation is based on total tax revenue, including sales tax on alcohol which has not been subsumed under GST.

Figure 7: Average tax growth rate indicates that some states may require compensation under GST



Note: Data for Telangana not available.
Sources: State Budget Documents; RBI State of State Finances; PRS.

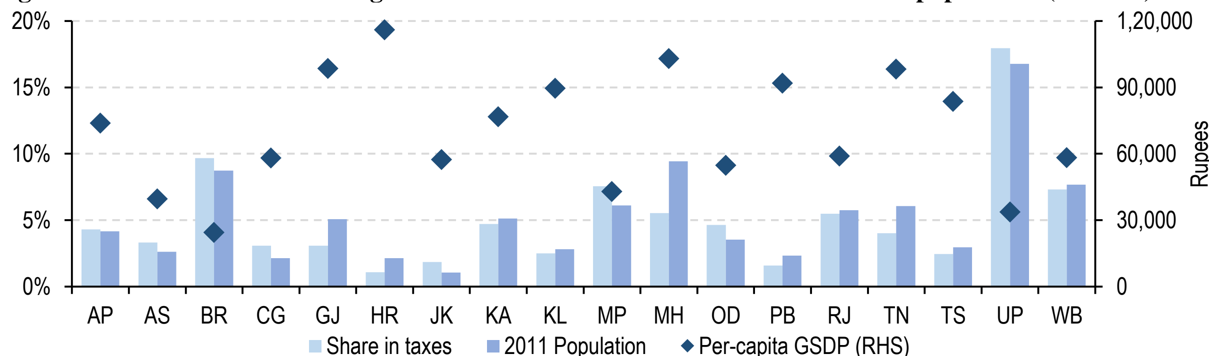
Increased flexibility in using central transfers; priorities remain the same

States are receiving more untied money from centre post 14th Finance Commission

The centre transfers resources to states under two broad heads: (i) share of central taxes, where there are no conditions on the manner in which the funds may be used, and (ii) grants-in-aid, for which the centre may lay down conditions on how these funds may be utilised.

The 14th Finance Commission recommended that the central government increase the share of central taxes devolved to states from 32% to 42% from 2015-16.[2] The methodology to distribute these taxes across states was based on five factors, each having a different weight. These factors included population of the state, per-capita income, area and forest cover. These factors were intended to address size (population and area) and redistribution (poorer states got a greater share), with an incentive for more forest cover. For example, Uttar Pradesh which has per-capita income below the national average was allocated more than its population share, while a richer state like Maharashtra got a lower share.

Figure 8: Poorer states receive higher share of devolved taxes than their share in population (2015-20)



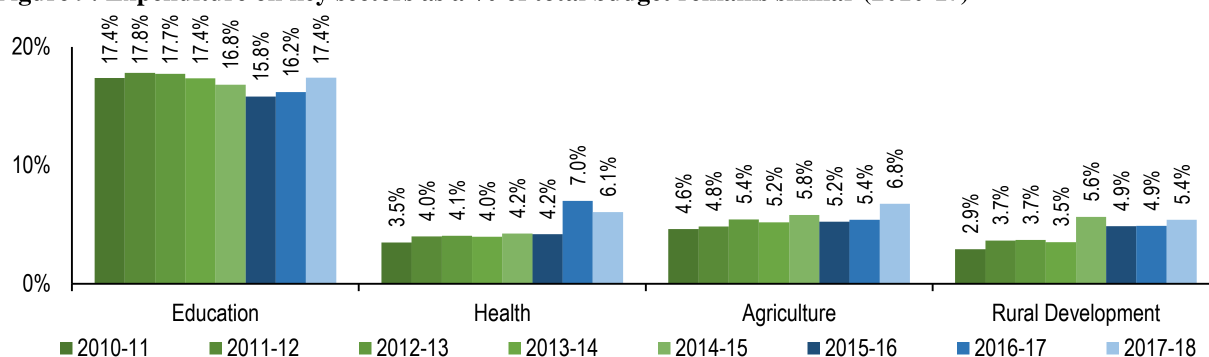
Note: Finance Commission does not provide data for Delhi.
Sources: Report of the Fourteenth Finance Commission (2015-20); PRS.

However, expenditure priorities appear to remain the same

Subsequent to the increase in central taxes devolved to the states, the fund sharing pattern for several schemes and programmes was revised. This included discontinuing and consolidation of schemes. The revision sought to give flexibility to states to decide which schemes they will continue implementing using the additional resources received from the centre.

State budgets presented after the implementation of these changes show that expenditure priorities of states have changed a bit. For instance, states spent 17.4% of their total expenditure on education between 2010-11 and 2014-15 (period of the 13th Finance Commission), which dropped to 16.5% in the three years of the 14th Finance Commission. Share of expenditure on health increased from 4% to 5.8% during this period, on agriculture from 5.2% to 5.8%, and on rural development from 3.9% to 5.1%.

Figure 9: Expenditure on key sectors as a % of total budget remains similar (2010-17)



Note: Figures for 2016-17 are revised estimates and 2017-18 budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

15th Finance Commission constituted

The 15th Finance Commission has been set up under the chairmanship of Mr. N. K. Singh.[3] The Commission will make recommendations for the 2020 to 2025 period on subjects including: (i) sharing of central taxes with states, (ii) principles which govern the distribution of central grants to states, and (iii) measures to improve the finances of states to supplement the resources of panchayats and municipalities.

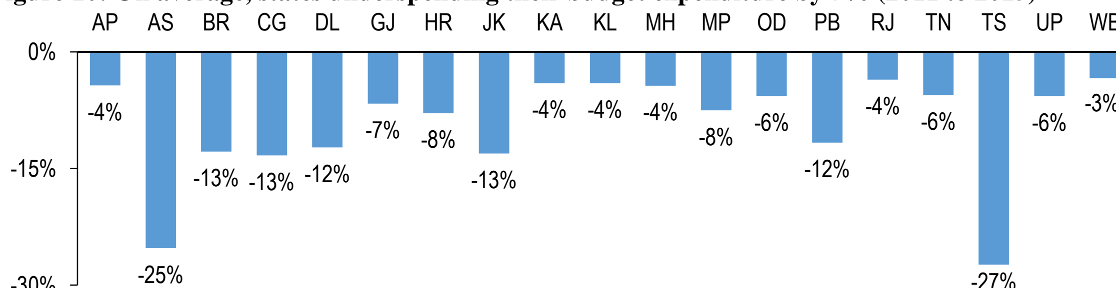
In addition, the Commission will study the impact of the GST on the finances of the central and state governments. It will also review the existing debt level of the centre and states and recommend a roadmap taking into account their debt and deficit. The Commission may also recommend performance based incentives for states in areas such as: (i) efforts made by states for population control, (ii) progress made in increasing capital expenditure and eliminating power losses, and (iii) progress made in promoting ease of doing business, among others.

States spend lower than budget estimate; expenditure on key sectors cut

States are spending lower than their budget estimates

At the beginning of a year, states estimate the total expenditure proposed to be incurred during the year. The actual spending may vary from this budget estimate. Between 2011-12 and 2015-16, states missed their spending targets consistently by 7%, implying that the actual spending was lower than the budget estimate. Telangana and Assam saw the highest underspending of funds.

Figure 10: On average, states underspending their budget expenditure by 7% (2011 to 2015)



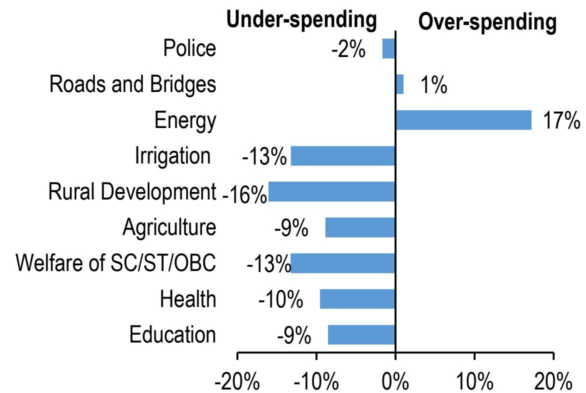
Note: Data for Telangana from 2014-15 onwards.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Rural Development and irrigation witness under-spending; higher expenditure on energy

On average, states spend about 80% of their budget on revenue expenditure and the remaining 20% on capital expenditure. Between 2011 and 2015, states witnessed an underspending of 6% in their revenue expenditure, and 16% in their capital expenditure.

Among various sectors, rural development witnessed the highest under-spending, followed by irrigation (13%), and welfare of SC/ST/OBCs (13%). On the other hand, states spent 17% more than their budget estimates on energy. This may be due to the additional expenditure incurred during 2015-16 to implement the UDAY scheme. The scheme was launched in November 2015, and as a result states could not have estimated expenditure on the scheme while presenting their budgets in March 2015.

Figure 11: Sector-wise underspending (2011-15)



Note: Over-spending implies that the actual expenditure was more than the budget estimate.
Sources: State Budget Documents; Reserve Bank of India; PRS.

Demonetisation and its impact on Kerala

In November 2016, currency notes of Rs 500 and Rs 1,000 were demonetised, implying that they could no longer be used as legal tender in the country. People were given a window till December 31, 2016 to exchange or deposit the demonetised currency notes.

The Economic Review - 2016 of Kerala noted the impact of demonetisation on the financial position of the state. It noted that 56% of the state's economy was dominated by cash-intensive sectors such as retail trade, hotels, restaurants, and transportation. As a consequence of withdrawal of currency notes, these sectors were hit. Further, around 60% of all deposits in the state are in co-operative banks, as against a national average of 20% deposits in co-operative banks. Therefore, restrictions on exchange and deposit of demonetised currency notes affected various sectors.

The Review noted that there was a slump in economic activity post demonetisation, and as a consequence the state saw a dip in stamp duty collections (from the real estate sector) and motor vehicle tax collections. This fall in revenue coupled with a decline in central transfers may either result in a bigger deficit for the state, or contraction in expenditure at the state level.

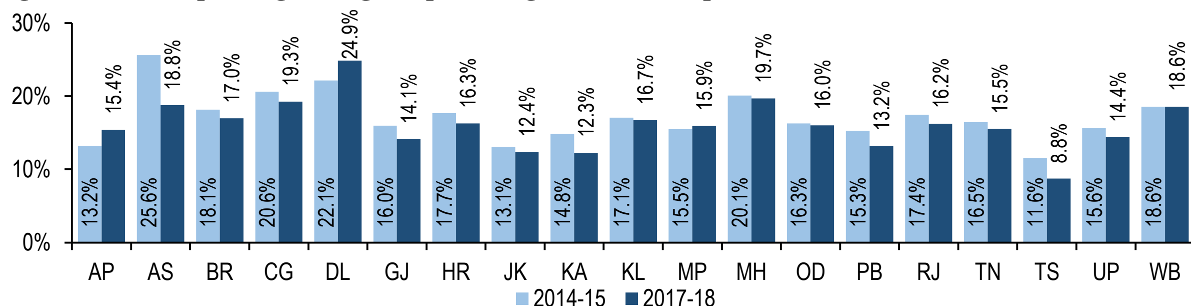
Source: Economic Review - 2016, Government of Kerala.

Spending by states on key sectors in 2014-15 and shift in 2017-18[4]

Education

In 2017-18, states are expected to spend 16% of their total expenditure on education. Typically, such expenditure is on schemes (such as Sarva Shiksha Abhiyan), construction and maintenance of school buildings, and payment of teacher salaries. Delhi is expected to spend the highest on education (25%), while Telangana has budgeted to spend the lowest (9%). Note that Delhi is an outlier on areas such as education and health as it does not spend much on police, agriculture and rural development.

Figure 12: Delhi spending the highest percentage of its total expenditure on Education in 2017-18

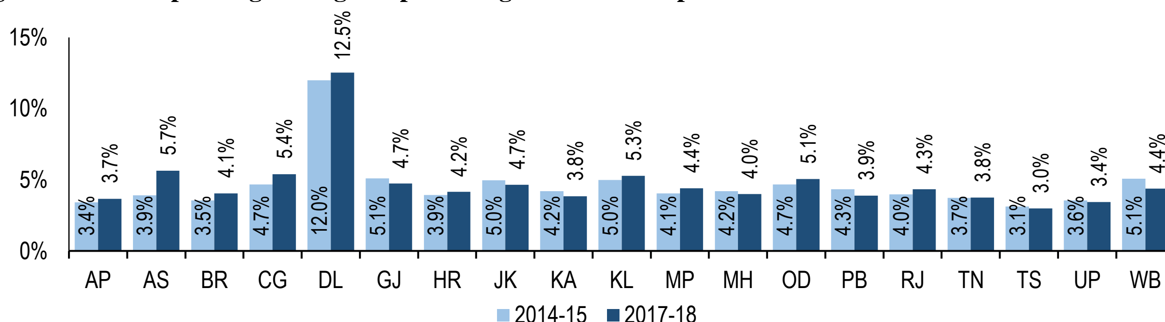


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Health

States are expected to spend 4% of their total expenditure on health in 2017-18. This spending is majorly on payment of salaries to doctors, and construction and maintenance of hospitals. It also includes expenditure on schemes such as the National Health Mission. Delhi has budgeted to spend the highest on health (13%), while Telangana is expected to spend the lowest (3%).

Figure 13: Delhi spending the highest percentage of its total expenditure on Health in 2017-18

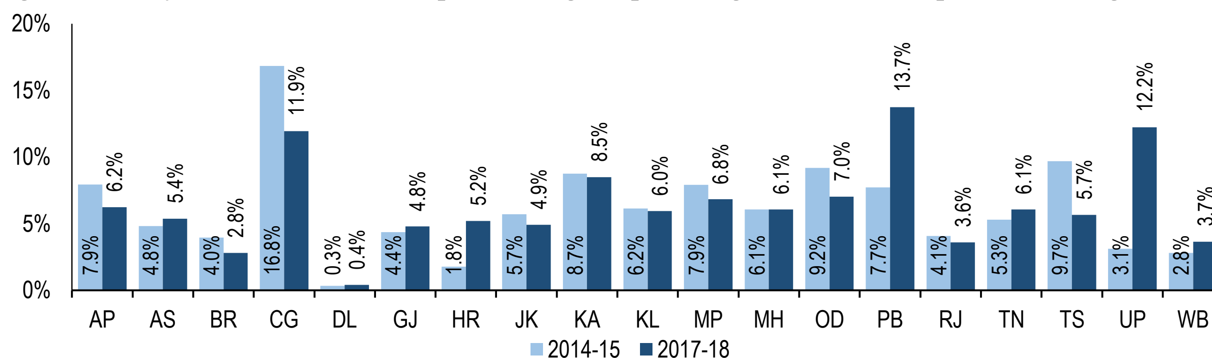


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Agriculture

In 2017-18, states are expected to spend 7% of their total expenditure on agriculture. This includes expenditure on schemes such as the Rashtriya Krishi Vikas Yojana, and those related to crop insurance. Punjab (14%), Uttar Pradesh (12%), and Chhattisgarh (12%) have budgeted to spend the most.

Figure 14: Punjab and Uttar Pradesh spend the highest percentage of their total expenditure on Agriculture

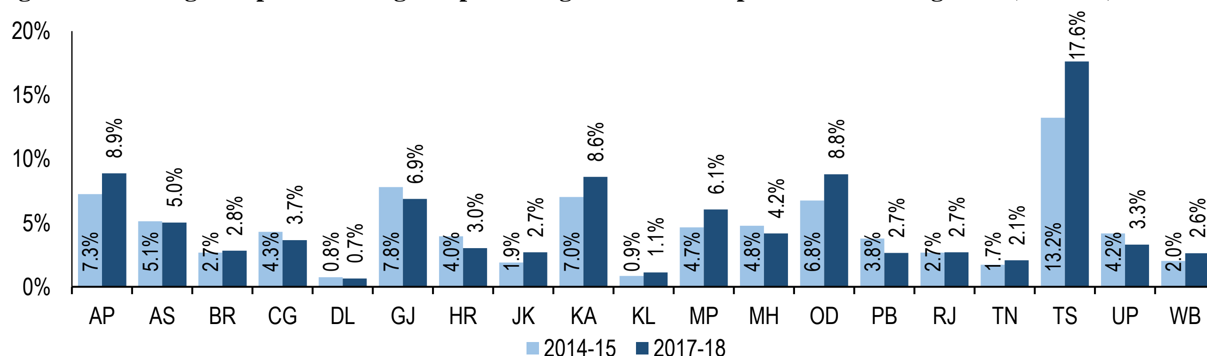


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Irrigation

In 2017-18, states are expected to spend 5% of their total expenditure on irrigation. This includes expenditure on the construction and maintenance of the irrigation network, and flood control. Telangana has the highest budget expenditure on irrigation (18%), followed by Andhra Pradesh (9%).

Figure 15: Telangana spends the highest percentage of its total expenditure on Irrigation (2017-18)

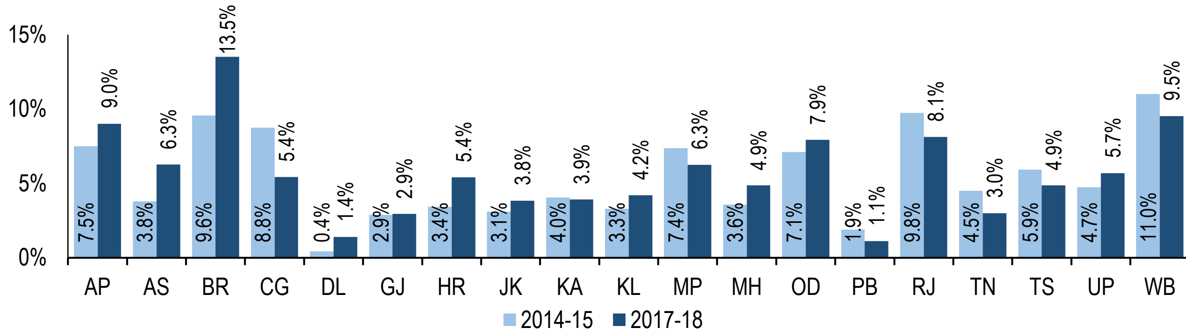


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Rural Development

In 2017-18, states are expected to spend approximately 6% of their total expenditure on rural development, on average. This includes expenditure on various rural development programmes (such as those related to sanitation and construction of roads), and implementation of schemes such as the Mahatma Gandhi National Rural Employment Guarantee Scheme (MNREGS). Bihar (14%) has the highest expenditure, followed by West Bengal (10%).

Figure 16: Bihar spending the highest percentage of its total expenditure on Rural Development in 2017-18

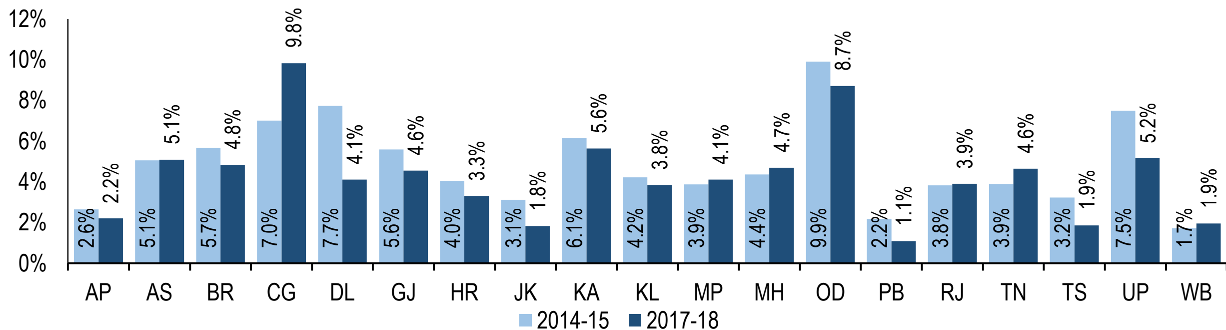


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Roads and Bridges

States have budgeted to spend 4% of their total expenditure on roads and bridges. This includes expenditure on the construction and maintenance of state highways and district roads. Chhattisgarh (10%), and Odisha (9%) have the highest allocations.

Figure 17: Chhattisgarh spends the highest percentage of its total expenditure on Roads (2017-18)

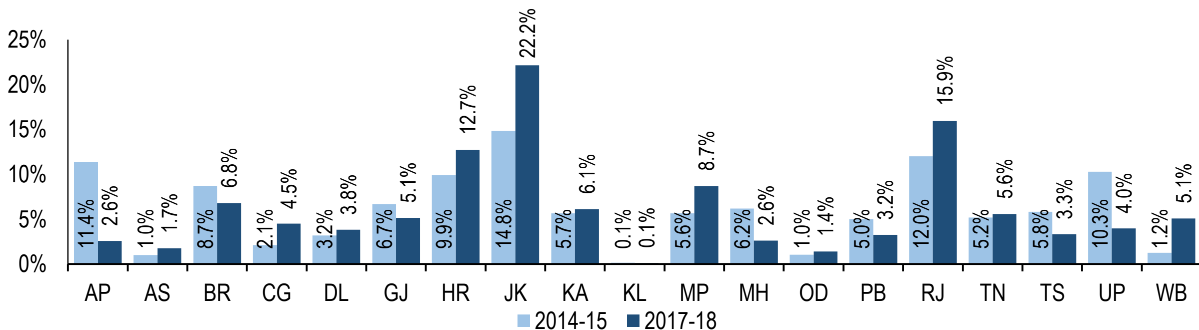


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Energy

In 2017-18, states are expected to spend 6% of their expenditure on energy. This includes expenditure on subsidy to consumers, power projects, and loans given to the power distribution companies. Jammu and Kashmir has budgeted to spend 22%, followed by Rajasthan (16%). Note that on average, states raise approximately 3.2% of their total tax revenue by levying a tax or duty on electricity.

Figure 18: Jammu and Kashmir spends the highest percentage of its total expenditure on Energy

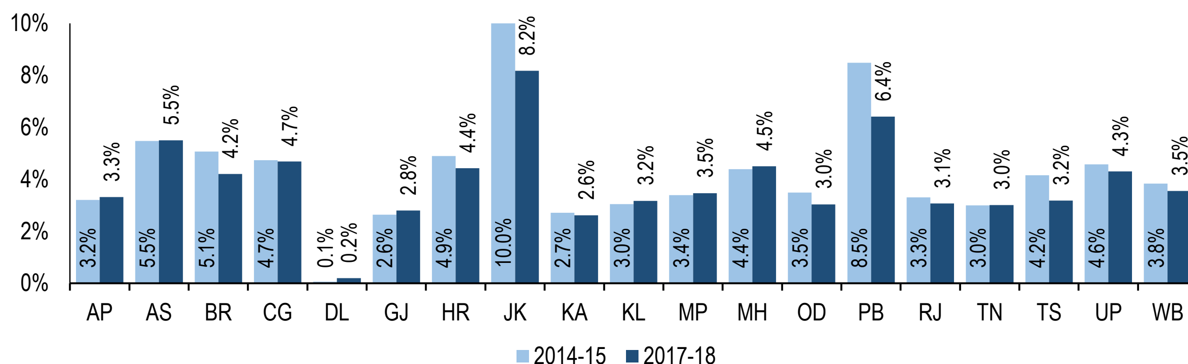


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Police

States have budgeted to spend 4% of their total expenditure on police. This includes expenditure on salaries, and construction and maintenance of accommodation for police personnel. Jammu and Kashmir (8%) and Punjab (6%) have the highest allocations. While the police in Delhi is under the central government, the state's expenditure is on a forensic laboratory.

Figure 19: Jammu and Kashmir and Punjab spend the highest percentage of their budget on Police

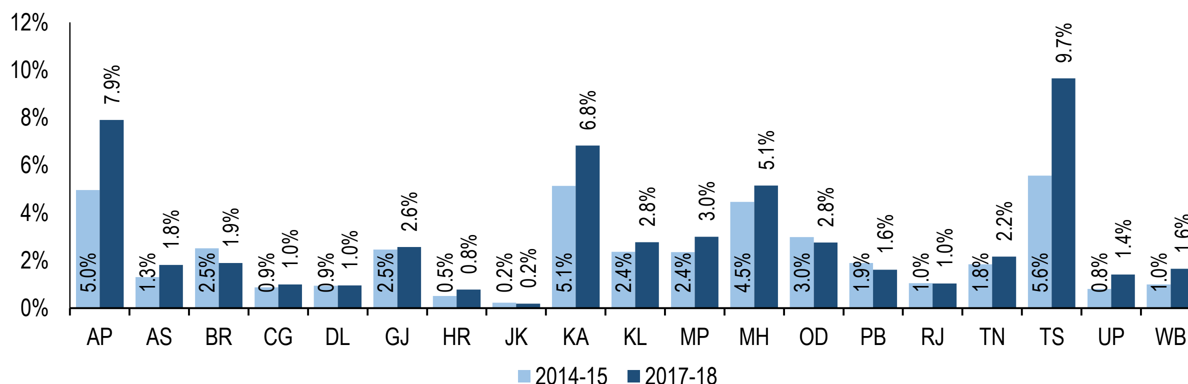


Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Welfare of SC/ST/OBCs

Welfare programs for SC, ST and OBCs include expenditure on scholarships, in addition to construction and maintenance of hostels for students. Spending on these programs may vary depending on the SC and ST population in the state. In 2017-18, Telangana is expected to spend 10% of its total expenditure on the welfare of SC, ST and OBCs, followed by Andhra Pradesh (8%), and Karnataka (7%).

Figure 20: Telangana and Andhra Pradesh spend the highest on Welfare of SC/ST/OBCs



Note: Figures for 2014-15 are actuals and 2017-18 are budget estimates.
Sources: State Budget Documents; RBI State of State Finances; PRS.

Deficits within limit for most states; 23% receipts spent on debt servicing

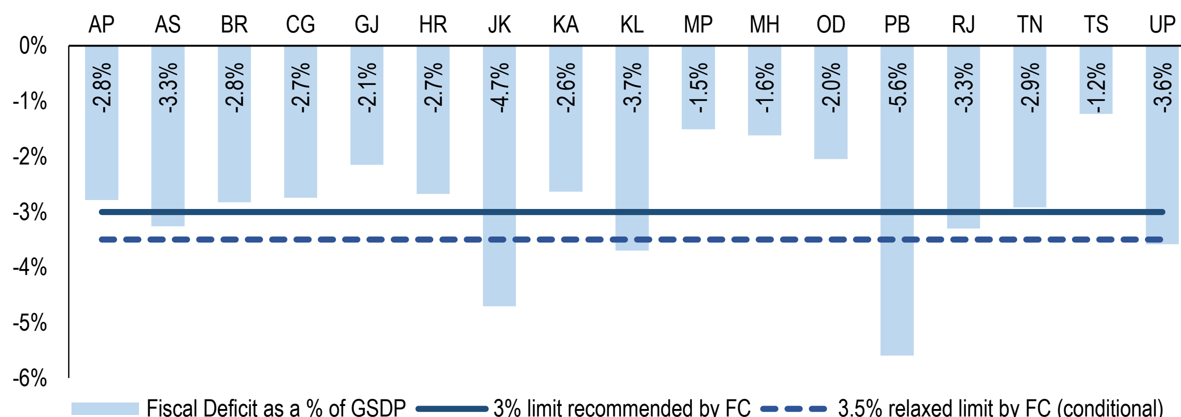
Fiscal deficit for most states under 3% GSDP; average at 2.9% across states

Fiscal deficit is the excess of government expenditure over its receipts. A high fiscal deficit of a government implies a higher borrowing requirement in a financial year. The borrowed funds may be spent by the state for various purposes, including on development activities and interest payments. In 2015, the 14th Finance Commission recommended that states continue to maintain a fiscal deficit at 3% of their GSDP. It suggested that the fiscal deficit limit be relaxed to a maximum of 3.5%, only if states were able to contain their debt and interest payments to specified levels. The relaxation would be allowed in the following cases: (i) 0.25% if the debt-GSDP ratio of the state was under 25% in the preceding year, and (ii) 0.25% if interest payments of the state were less than or equal to 10% of its revenue in the preceding year.[2]

Over the period between 2012-13 and 2017-18, most states maintained their fiscal deficit within the range recommended by the Finance Commission. States that crossed the recommended limit include

Jammu and Kashmir (4.7%) and Punjab (5.6%). On the other hand, Madhya Pradesh, Maharashtra, and Telangana had the lowest fiscal deficit.

Figure 21: Most states maintain fiscal deficit within limit (2012-17)



Note: Average for Telangana for four out of the six years. Data for West Bengal unavailable.
Sources: State Budget Documents; PRS.

What is the FRBM Act?

In 2003, Parliament passed the Fiscal Responsibility and Budget Management Act (FRBM Act) which prescribed limits for deficits and outstanding liabilities of the central government. In the following years, several states passed their respective FRBM Acts, similar to the central FRBM Act. The objectives of the FRBM Acts are to: (i) encourage disciplined government borrowings, so that the burden of repayments is not passed on to future governments, and (ii) ensure governments' borrowing do not crowd-out private borrowing (individuals and companies). Centre and state governments set targets to reduce their deficits and liabilities to achieve these objectives.

Reviewing the FRBM Act

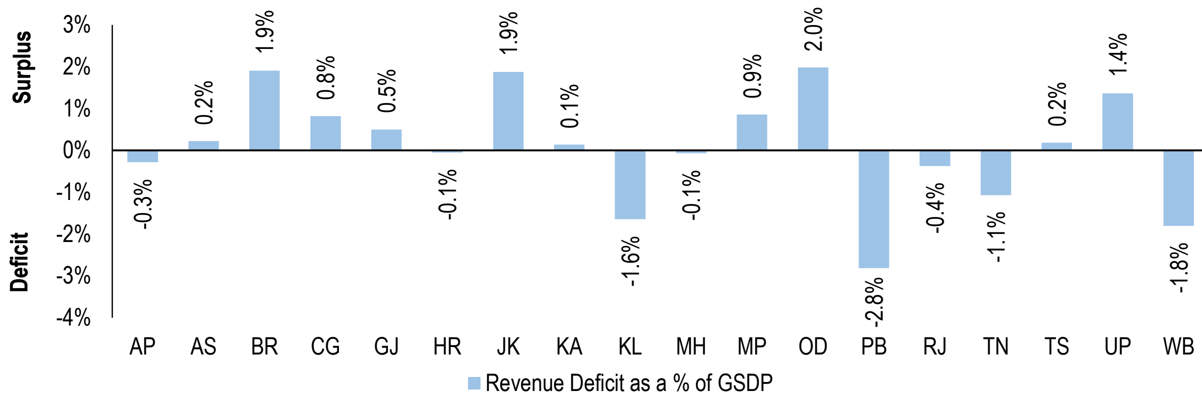
In 2017, the FRBM Review Committee (Chairperson: Mr. N.K. Singh) reviewed the status of fiscal governance across the centre and states. It suggested using debt (i.e., total liabilities at the end of the year) as the primary target for fiscal policy, as opposed to the current way of using fiscal deficit (i.e., borrowing requirement for the year). The Committee recommended that a debt to GDP ratio of 60% should be targeted for the entire country, with a 40% limit for the centre and 20% limit for the states. The Committee suggested that grounds on which the government can deviate from these targets should be clearly specified, and governments should not be allowed to notify other circumstances, unlike in the current FRBM Acts.

Most states have a revenue surplus

Revenue deficit is the excess of revenue expenditure (such as spending on salary and interest payments) over revenue receipts (such as taxes and fees received from providing services such as state transport and education) of the government. A revenue deficit means that states need to borrow to meet expenses which do not create any assets. Over the period from 2012-13 to 2017-18, Punjab (2.8%), West Bengal (1.8%), and Kerala (1.6%) had the highest revenue deficits. Note that the 14th Finance Commission recommended that states should eliminate their revenue deficits.

A revenue surplus implies that the revenue of states is sufficient to meet their expenditure requirements in a given year. A high revenue surplus indicates: (i) the state can create capital assets; or (ii) it can pay down outstanding liabilities. Over the period from 2012-13 to 2017-18, states such as Odisha, Jammu and Kashmir and Bihar had the highest revenue surplus.

Figure 22: Most states eliminate revenue deficit (2012-17)

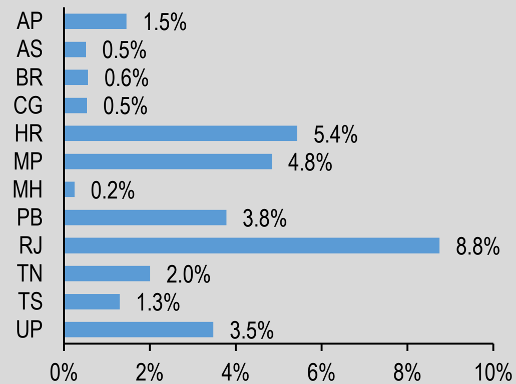


Note: Average for West Bengal for five years, Telangana for four years, and Tamil Nadu and Uttar Pradesh for three years. Data for Delhi unavailable.
Sources: State Budget Documents; PRS

On average, debt taken over by states under UDAY is 3% of their GSDP

In November 2015, the central government launched the Ujwal Discom Assurance Yojana (UDAY), to improve the financial situation of state-owned power distribution companies (discoms). Prior to its introduction, the debt of the discoms stood at over Rs 4 lakh crore as of March 2015.[5] States signing up for the UDAY scheme were required to take over 75% of the discoms' debt over a period of two years (50% of the debt in the first year of the scheme, and the remaining 25% in the second year). The scheme provided that the debt taken over from discoms would not be included in the fiscal deficit for 2015-16 and 2016-17 for the purpose of the FRBM Act limits.[5]

Figure 23: Debt of DISCOMs agreed to be taken by states as a percentage of their GSDP (2015-16)



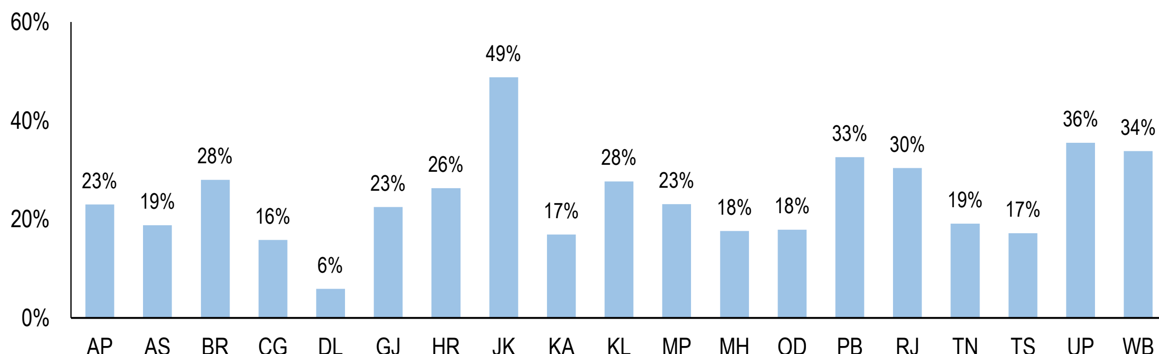
Sources: MoUs signed by states on UDAY; PRS.

Among the 19 states in this study, 12 states participated in the scheme and took over 75% of their discoms' debt. This amounts to Rs 2,19,834 crore, which increased the debt burden for these states. For example, Rajasthan, took over discom debt worth 8.8% of its GSDP, while the figure for Haryana was 5.4%, Madhya Pradesh 4.8%, Punjab 3.8%, and Uttar Pradesh 3.5%.

States' outstanding liabilities worth 24% of their GSDP

Outstanding liabilities refer to debt accumulated from financing the fiscal deficit in the past. Higher liabilities indicate a higher obligation for states to repay loans in the future. The FRBM laws of states usually specify limits on the outstanding liabilities as a percentage of GSDP. Typically, these limits are set at 25% of GSDP in a year. In 2016-17, Jammu and Kashmir had the highest liabilities (49% of its GSDP), followed by Uttar Pradesh (36%). On the other hand, Delhi had the lowest outstanding liabilities (6%).

Figure 24: Outstanding liabilities of states at 24% of GSDP (2016-17)



Sources: RBI State of State Finances; PRS.

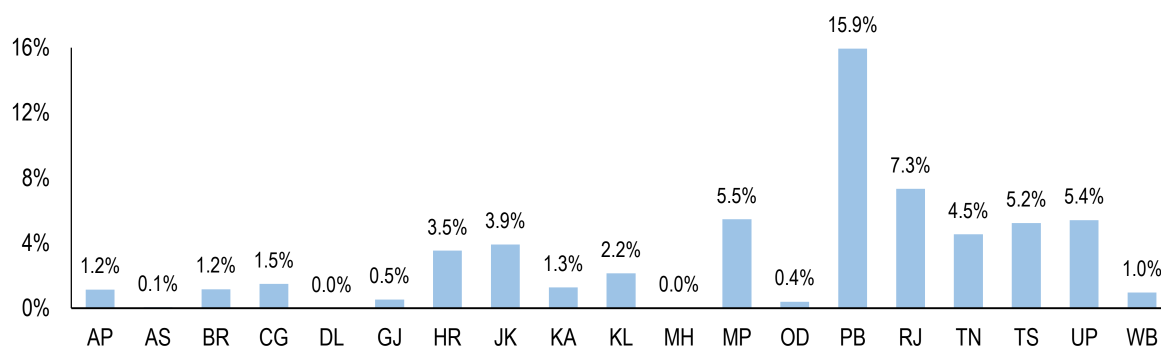
States have provided guarantees worth 3% of their GSDP outside their budgets

As discussed earlier, borrowings by states have led to the accumulation of outstanding liabilities equal to 24% of their GSDP on an average. However, this number does not include a few other liabilities that are contingent in nature, which states will have to honour in certain cases.

State governments provide guarantees on loans taken by state government owned public sector enterprises (SPSEs), such as discoms. This may be because these enterprises have a poor credit profile and a government guarantee will make it easier for them to obtain a loan. However, if these SPSEs default on their loan repayments, state governments will be liable to honour their guarantee and make the repayment instead. Hence, these guarantees are liabilities that are contingent in nature. As of 2015-16, states have accrued such contingent liabilities worth 3% of their GSDP. This is in addition to the 23% outstanding liabilities they have.

RBI has noted that these contingent liabilities are a risk to state governments owing to the large outstanding debt and losses of these SPSEs.[6] It also noted that the liabilities of states may increase if they implement recommendations of the Pay Commission in 2017-18.

Figure 25: Outstanding guarantees as percentage of GSDP (2015-16)

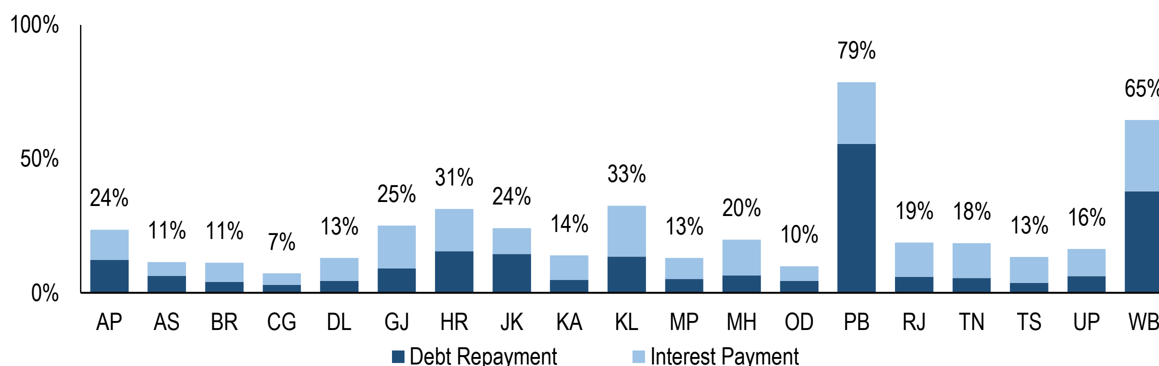


Sources: State Budget Documents; RBI State of State Finances; PRS.

States spend 23% of their non-debt receipts on interest and debt repayment

States spend nearly 23% of their receipts (excluding borrowings) on servicing their debts in the form of principal and interest payments. This amount is higher for states like Punjab and West Bengal, where 79% and 65% of the states' receipts are spent on servicing debt, respectively. Higher debt servicing costs constrain spending on other priorities.

Figure 26: Punjab and West Bengal spend a high portion of non-debt receipts on servicing debt (2013-17)



Sources: State Budget Documents; PRS.

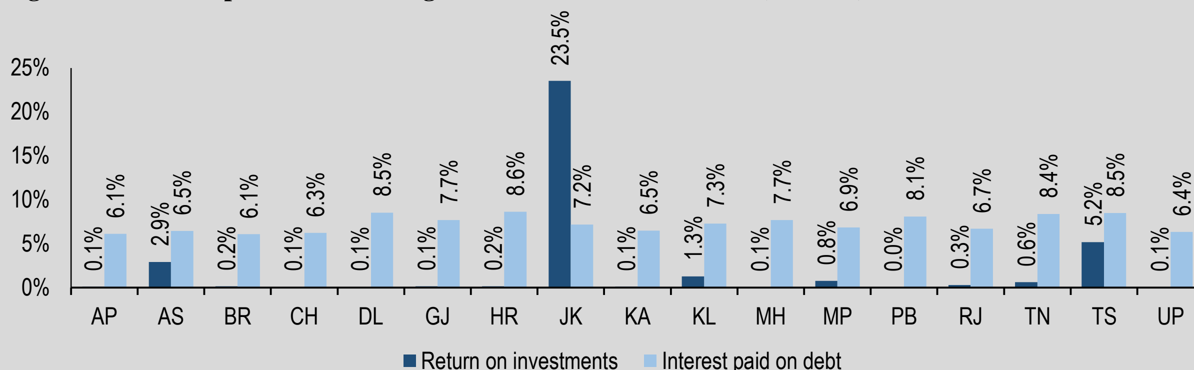
States borrow at a rate of 7.4% while they earn a return of 0.2% on their investment

State governments invest in Statutory Corporations, Rural Banks, Joint Stock Companies, Co-operatives and Government Companies. In 2015-16, the average return on these investments across states was 0.2%. On the other hand, states borrow funds to finance deficits. In 2015-16, states paid 7.4% interest on these borrowings.

The Comptroller and Auditor General (CAG) has advised states to ensure that they receive a better value for their investments, otherwise funds borrowed at high cost will continue to be invested in projects earning low

returns.[7,8,9] Barring Jammu and Kashmir, which borrowed at an interest rate of 7.2%, and received returns at 23.5%, all other states witnessed significantly lower rate of returns on their investments. Note that Jammu and Kashmir received high returns due to its investment in the Jammu and Kashmir Bank Limited.

Figure 27: Interest paid on borrowings and return on investments (2015-16)



Sources: Comptroller and Auditor General (2015-16); PRS.

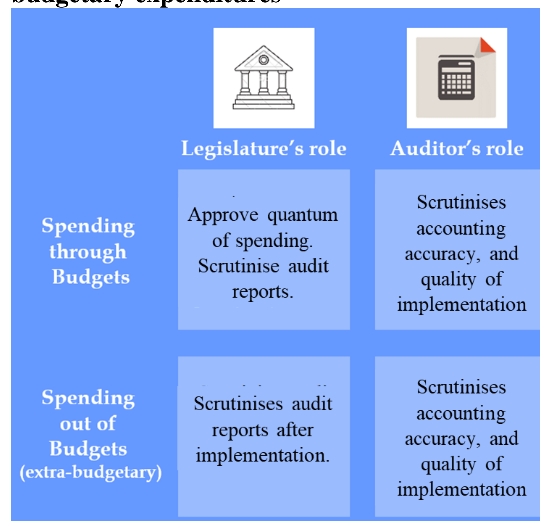
Extra-budgetary spending indicates inadequate public scrutiny of expenditure

State governments often incorporate PSUs to execute some of their priorities. For example, the Tamil Nadu State Transport Corporation Limited which runs buses in Tamil Nadu is an incorporated entity, owned by the state government. These corporations have their own revenue model, and their finances are separate from the state government. This is to ensure financial autonomy to the PSU.

Some states have been delivering several public services through specially incorporated entities (e.g., Kerala Infrastructure Investment Board, and Maha Infra). These entities implement services such as providing drinking water, and construction of schools, hospitals, and housing for the poor. Such practices may lead to some issues.

- The financial and performance audit of these programmes is undertaken by the CAG after their implementation. The CAG reports are examined by the Committee on Public Undertakings of the state legislature. However, their finances are not approved by the legislature of the state *prior* to the expenditure. It may be important to note that the legislature is responsible for scrutinising budgets and also examine the impact of policies being implemented by the government.
- Some of these projects such as construction of schools may not have a revenue model. For such projects, state governments need to provide guarantees on the loans taken by the implementing agencies. While governments define and implement policy through these agencies, the debt taken by these agencies does not appear in the books of state governments.

Figure 28: Scrutiny of budgetary and extra-budgetary expenditures



Sources: PRS.

Telangana: Two Bedroom Housing Scheme, and Mission Bhagiratha

The Telangana government proposed to implement a Two Bedroom Housing Scheme (2.6 lakh houses for poor), Mission Bhagiratha (drinking water supply to 12.5 lakh households) and other programs to promote horticulture and urban development. The state plans to use extra-budgetary mechanisms to implement these programs. For this, it has started various public sector undertakings to implement these programs. While the public sector undertakings borrow money to implement these programs, the government provides guarantees on such loans.

Sources: Telangana Budget Documents; PRS.

1. Delhi Value Added Tax Act, 2004; Tamil Nadu Value Added Tax Act, 2006.

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

3. 'Cabinet approves setting up of the 15th Finance Commission', Press Information Bureau, Cabinet, November 22, 2017; S.O. 3755(E), Gazette of India, Ministry of Finance, November 27, 2017, http://egazette.nic.in/WriteReadData/2017/180483.pdf.

4. Data has been taken from the Annual Financial Statement of state budget documents.

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

6. State Finances: A Study of Budgets 2016-17, Reserve Bank of India, May 2017, https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0SF2016_12051728F3E926CFFB4520A027AC753ACF469A.PDF.

7. Report of the Comptroller and Auditor General of India on State Finances for the year ended 31 March 2016 for Rajasthan, http://cag.gov.in/sites/default/files/audit_report_files/Rajasthan_Report_No_6_of_year_2016_State_Finances.pdf.

8. Report of the Comptroller and Auditor General of India on State Finances for the year ended 31 March 2016 for Maharashtra, http://cag.gov.in/sites/default/files/audit_report_files/Maharashtra_Report_No_6_of_2016_on_State_Finances.pdf.

9. Report of the Comptroller and Auditor General of India on State Finances for the year ended 31 March 2016 for Gujarat, http://www.cag.gov.in/sites/default/files/audit_report_files/Gujarat%20Report%20No%205%20of%202016%20State%20Finances.pdf.

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