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State Finances – A Report

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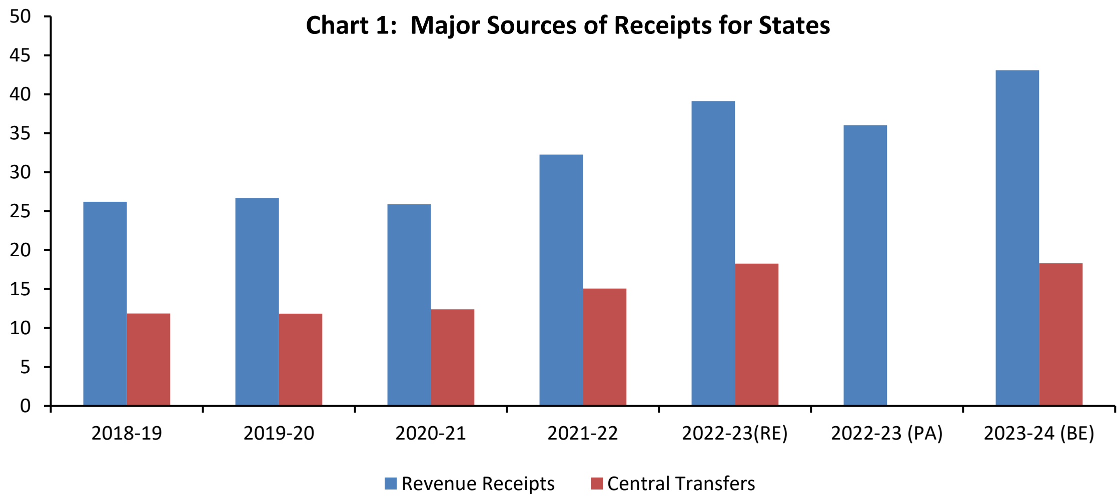
The RBI has released its annual Study of State Finances and observed that State governments have embarked assuredly on the path of fiscal consolidation. There has been a general trend of crowding in private investment by way of improving the quality of expenditure of both central and state governments. The Central government has, in a bid to stick to the path of fiscal consolidation, reduced its Gross Fiscal deficit from 6.4 per cent in FY23 to 5.9 per cent in FY24. Following suit, the States governments have budgeted a 3.1 per cent of Gross Fiscal Deficit (GFD) for FY24 as compared to 3.4 per cent in the preceding financial year. So, the combined government GFD is 8.6 per cent as compared to 9.6 per cent in the previous financial year as per RBI's estimates.

Moreover, even as the Union government has repeatedly emphasized on the improvement of the quality of expenditure by focusing its own expenditure more on the capital side, it has also nudged the States to follow suit and increase their localized capital expenditures, which the State governments have been doing, and thus even though the overall expenditures are rising, the State governments have been channeling their expenses more towards capital expenditure as opposed to revenue expenditure, especially in the post pandemic period. The RECO ratio, i.e. the ratio of revenue expenditure to capital outlay which indicates the quality of expenditure has been declining indicating an improvement in the quality of spending for States. Typically for FY24, State governments have been slightly more profligate in Q2FY24, likely reducing their fiscal capacity slightly for the second half of the year.

While so far, State governments have been able to manage their resources, both own and as given by the Center, some of the States have indicated adverse trends such as reverting to the old pension scheme (OPS), and such trends if perpetuated can result in increase in the share of revenue expenditure in total expenditure thereby adversely affecting the quality of spending resulting in reduced fiscal capacity for such States. RBI estimates suggest that if all States revert to the OPS, the burden on the exchequer would be 4.5 times that as compared to the new pension scheme (NPS) and the revenue expenditure will likely reach 0.9 per cent of GDP by 2060.

Receipts: The major sources of State government receipts are the State's own tax revenues, non-tax revenues, devolution of taxes from the Center, and grants from the Center, primarily channeled through Centrally Sponsored Schemes (CSS) and Finance Commission grants. This is along with the non-debt capital receipts such as recovery of loans and advances and miscellaneous capital receipts. In general, tax reforms such as

GST were aimed at unifying the complicated tax structure prevalent pre-GST. Also, the government has focused on controlling the revenue leakages through the GST system resulting in stable and robust tax revenues in the recent years. This has also meant healthy tax devolution from the Center to the States in the last 5 years. The tax devolution is currently at 41 per cent, and aimed at reducing the vertical fiscal imbalances created by the implementation of GST. Vertical fiscal imbalances are created due to the fiscal gap i.e. the disparity in the revenue generating capacity vis-à-vis expenditure responsibilities across the various tiers of government within a federation such as India.



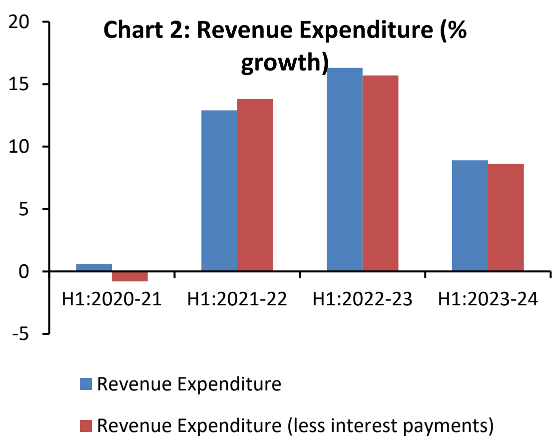
Source: State Finances: A study of State Budgets of 2023-24[1]

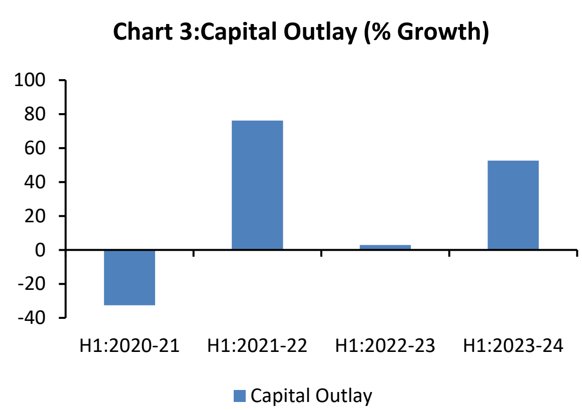
Provisional accounts (PA) point to a moderation in revenue receipts for the States on account of lower tax revenues and grants from the Center. Grants from the Center have stabilized at roughly Rs.18.3 lakh crore in FY24, similar to the revised estimates of FY23. The exact estimate of the central transfers is not available in the provisional accounts for FY23. The States have estimated a strong increase of ~20 per cent in the revenue receipts for FY24 (BE), over the provisional accounts of FY23. For H1FY24, the States had garnered 40 per cent of the Budget Estimates, a tad lower than 41.3 per cent of Budget Estimates in the preceding financial year. Also, as expected the rate of growth for both the State's tax and non-tax revenues nearly halved during the year owing to a high base of the previous year and actual stabilization of tax collections in the central as well as state coffers over the period, i.e. Tax revenue growth slowed from a robust 32.4 per cent in FY23 to 14.6 per cent in FY24, while non-tax revenue for States slowed from 33.5 per cent in FY23 to 19.6 per cent in FY24.

[1] Provisional Account (PA) for Central Transfers is not available for FY23.

RBI has undertaken a club convergence analysis. Convergence analysis is useful in measuring horizontal inequities, as the analysis says that poorer regions grow faster than the richer regions and eventually catch up. The analysis indicates that richer States are converging faster as compared to poorer States, and thereby the analysis suggests that horizontal fiscal imbalances are also widening over time among States. Poorer States are naturally constrained by multitude of factors, however transfers from the Union government can aid in mitigating fiscal gaps.[2]

State Expenditure: Following the Center's expenditure patterns the States have also improved the quality of expenditure with the revenue expenditure growth at 7.8 per cent and 10 per cent respectively in Q1 and Q2FY24, as compared to the growth rates of 22.1 and 22 per cent in the corresponding period in the previous year. In the RBI's half yearly review of the Union government's finances, the authors point to a marked shift in the pattern of government's handling of the Gross Fiscal Deficit, which used to cross the 50 per cent mark in the first of the year itself, sometime reaching even as high as 74 per cent (FY18). In recent times, the GFD is more evenly distributed since the revenue collecting is evenly spaced primarily due to the stable monthly distribution of the GST collections.





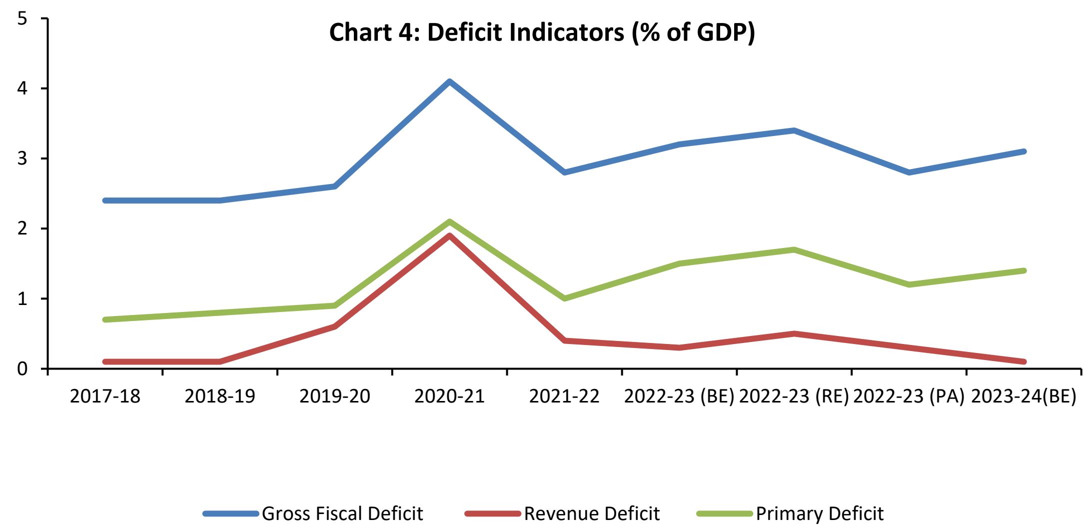
Source: State Finances: A study of State Budgets of 2023-24

Also, operational changes such as changing the accounting year of RBI from July-June to the standard April-March has resulted in an earlier transfer of the RBI dividend from August to May, which results in a larger non-tax revenue receipt for the Union government every year. While receipts are front loaded, expenditure is delayed with maximum expenditure happening in the last quarter of the financial year. This also implied more fiscal room for the government to budget and forecast more accurately the

[2] Government Finances 2023-24: A Half Yearly Review by Harshita Yadav et al RBI Bulletin December 2023

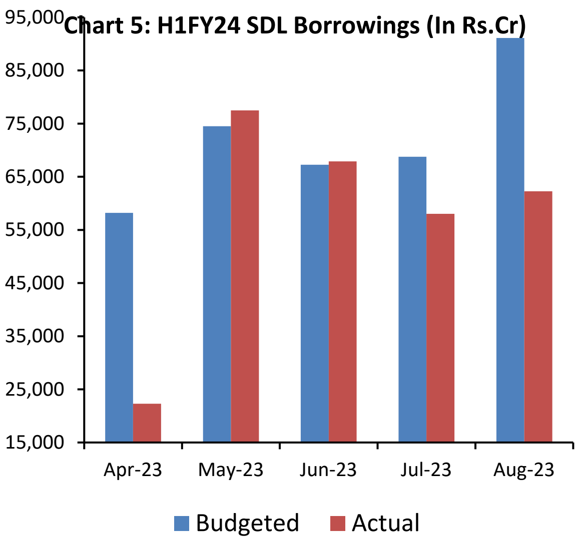
level of GFD in a given month, and an equally stable receivable amount through tax devolution to the States. The RECO ratio, i.e. the revenue expenditure to capital outlay for the States has been improving as it is for the Central finances. As per RBI estimates, the RECO improved from 7.3 in Q1FY23 to 5.6 in Q1FY24, and from 11.6 in Q2FY23 to 7.2 in Q2FY24. A lower reading indicates a better quality of spending.

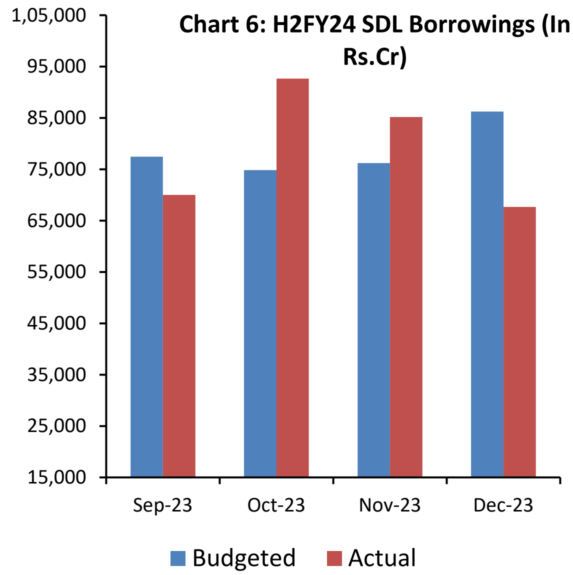
Fiscal Indicators: Deficit indicators show mixed trends, while GFD has increased slightly to 3.1 per cent for FY24 as compared to the provisional accounts; revenue deficit has moderated significantly to 0.1 per cent of GDP, while primary deficit has inched up slightly from 1.2 per cent in the provisional accounts to 1.4 in the FY24(BE)



Source: State Finances: A study of State Budgets of 2023-24

Deficit Financing: The major source of GFD financing for States is borrowing in the open market, or market borrowing in short. In recent years the States have overestimated their borrowings substantially as the RBI study shows. For example in FY23, the aggregate actual borrowings of all States fell short by a significant 24 per cent as compared to the indicative calendar announced at the beginning of each quarter. This has been a repeated trend amongst State governments and even the RBI has no control over these phenomena since it is decided by the State finance ministries as per their requirements and other factors such as interest rate environment and term premia. Of late, States have been diversifying the term structure from issuing merely 10 year bonds to issuing longer tenor bonds since there is healthy demand from investors such as pension funds and insurance companies. The gross market borrowings for FYTD24 were 26.4 per cent higher than in the corresponding period last year, in a large part due to the contraction of 7.6 per cent seen in FY23. Even during FY24, the gap in the indicative calendar and the actual borrowed amount remains as significant as 18 per cent for H1FY24. This trend might not continue in H2FY24 as actual borrowings have exceeded budgeted borrowings for October and November 2023. Also, as per our estimates we expect the states to announce borrowings close to Rs.3.7-3.8 Lakh Crore in the final quarter of FY24, as a total redemption pressure is close to Rs. 95,414 Crore if we account for the Ujjwal Discom Assurance Yojana (UDAY) bond redemptions of Rs.16,021 Crore in Q4FY24.





Source: RBI, STCIPD Research

Outlook: The situation of fiscal balances for States has no doubt improved overall, but state wise fragilities remain especially as to the liabilities of some northern and north eastern states like Punjab, Himachal Pradesh, and Arunachal Pradesh ranging between 45-50 per cent, which impinges on these states' fiscal capacity. Although these States are able to raise funds through market borrowings owing to backing of the Central government, clearly the state of public finances is not sustainable. On a general level, it is recommended in the report that States should raise the level of financial independence from the Center to foster greater fiscal federalism going ahead. This implies greater efforts by the States to manage their finances effectively and more important, greater dependency on own tax and non-tax resources for public expenditures. The reversal to old and dated schemes such as the Old Pension Scheme, would unnecessarily put an additional fiscal burden on State finances, which in the current situation would mean going off the path of fiscal consolidation.

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