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RBI's study of state finances 2023-24: Key takeaways

Executive Summary

- Fiscal discipline at the sub-national level: States contained Gross Fiscal Deficit (GFC) at 2.8% of Gross Domestic Product (GDP) in FY22 due to improved revenue deficit.
- Expenditure dynamics: Revenue expenditure growth of the states slowed to 8.9%, leading to higher capital outlay at 52.6%. States' committed expenditure accounts for 4.5% of GDP. Expenditure quality of the states improved with REVCO at 5% (ratio of revenue to capital outlay).
- Vertical Fiscal Imbalance: GST has increased tax buoyancy for the states and not increased vertical imbalance
- The current VFI stands at 0.48, similar to the pre-pandemic level
- The average budgeted buoyancy for all states is 0.74, while the realised buoyancy is lower at 0.55. This shortfall in revenue would necessitate unexpected deficit financing
- Fall in outstanding liabilities: States' outstanding liabilities have fallen from 31% in FY21 to 27.6% of GDP for FY24. States' reliance on market borrowings reduced to 76% in the budgeted GFD for FY24.
- Expenditure quality: The projected ratio of revenue expenditure to capital outlay (RECO) for the States is expected to decrease to 5.0 in FY24 from 6.0 in FY23
- The realised tax revenue is less than the maximum (tax capacity). The tax effort of States ranges between 0.71 to 0.99 during the estimation period, with an average tax effort of 0.81

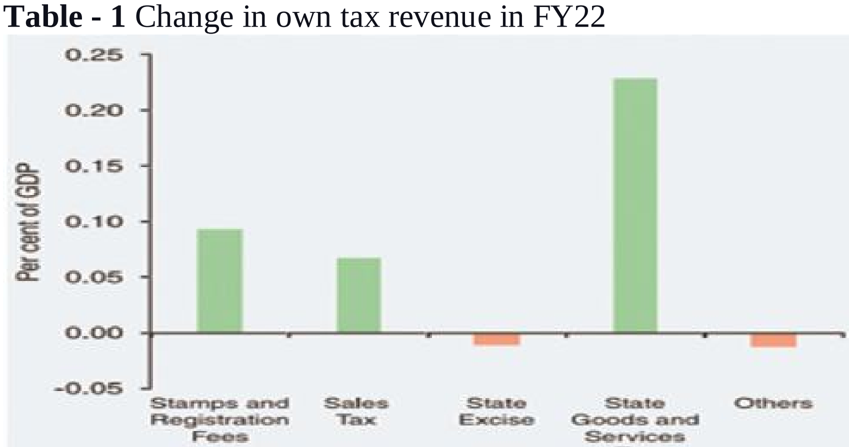
On Key fiscal indicators

GFD: The ratio of States' consolidated GFD to GDP decreased from 4.1 percent in 2020-21 to 2.8 percent in 2021-22. This decline was primarily due to reduced spending on revenue expenditure and an uptick in revenue collection. This has led to an improvement in revenue deficit. 19 States and Union Territories have projected a GFD-GSDP ratio that surpasses the FRL limit of 3 percent.

Revenue Receipts: The revenue receipts of the States experienced a notable rise of Rs. 36.04 lakh crore (13.2% of GDP) in FY23 Provisional Accounts (PA). This increase in revenue collections was propelled by a surge in tax revenue, encompassing both own taxes and tax devolution, alongside an elevation in non-tax revenue. As per the RE states' own revenue constitutes Rs. 20.86 lakh crore of which Rs. 18.02 lakh crore comes from own tax revenue and Rs. 2.84 lakh crore from own non-tax revenue. This surge compensated for the decline in grants received from the Centre. As per the PA the grants - in aid slowed down to Rs. 6.57 lakh crore, which is 2.4 percent of GDP.

Own Tax Revenue: Among the own tax revenues, contributions to the revenue increase were observed from stamp duty and registration fees, sales tax, and State Goods and Services Tax (SGST). However, there was a decrease in revenue derived from excise duties, as well as taxes and duties associated with electricity. SGST, sales tax, and States' excise duties constitute around 79 percent of the States' own tax revenue collection (Table - 1).

Table - 1 Change in own tax revenue in FY22



Vertical Fiscal Imbalance: the fiscal gap arising from the disparity between the revenue generation capacities and expenditure responsibilities. Following are the major observations on VFI:

- There was no major increase in VFI after the implementation of GST in 2017-18
- The VFI moved in a narrow range of 0.48-0.51 during 2017-18 to 2019-20
- The current VFI stands at 0.48, similar to the pre-pandemic level
- Kerala's VFI is 0.40, better than many north and north eastern states

State-specific measures to augment revenue:

- Kerala and Karnataka are aiming to reduce disparities between property guidance values and market values to increase tax collection from registration and stamp duties
- Himachal Pradesh's Sadbhavna Yojana addresses pending cases under different tax Acts
- Maharashtra and Rajasthan are contemplating continuation of amnesty programs to resolve pending cases, which in turn is expected to unlock tax arrears receivables
- Kerala's Social Security cess on Indian Made Foreign Liquor (IMFL) and fuel sales
- Goa's Green cess on non-Goan vehicles, and Himachal Pradesh's water and milk cess.
- Kerala is revising mineral royalties

States' Own tax revenue buoyancy

- The actual buoyancy observed was lower, indicating that the revenue collected was less than what was initially estimated.
- The average budgeted buoyancy for all states is 0.74, while the realised buoyancy is lower at 0.55. This shortfall in revenue would necessitate unexpected deficit financing.

Expenditure scenario

- **Revenue expenditure:** States' revenue expenditure (as a percent of GDP) declined in 2021-22 at 14.2 percent from the pandemic peak of 2020-21 at 14.9 percent, reflecting fiscal consolidation efforts. As per the PA it stands at 13.5 percent in FY23.
- Allocations for various sectors under development expenditure, including education, sports, art and culture, relief for natural calamities, urban development, agriculture and related activities, and rural development, were decreased.
- Conversely, there was an increase in expenditure on the power sector and medical and public health. The latter increase signifies the States' response to the second wave of COVID-19. The reduction in non-developmental expenditure was mainly widespread across various areas.
- In FY24, the revenue expenditure of the States is budgeted at 14.4 percent of GDP with social sector expenditure6 at 8.0 percent of GDP. Committed expenditure, which includes interest payments, administrative services and pensions, declined marginally to 4.5 per cent of GDP in FY23 and is expected to remain at the same level.
- Capital Expenditure: In the fiscal year FY22, the capital outlay of States experienced a robust growth of 28.7 percent. This increase in capital outlay was notably more pronounced in the agricultural sector, particularly in areas like food storage and warehousing. However, based on the provisional accounts, the capital outlay of the States saw an increase of 14.3 percent in FY23.
- When excluding central transfers amounting to Rs. 0.81 lakh crore under the Scheme for Special Assistance to States for Capital Investment, the capital outlay of the States in FY23 (as per provisional accounts) stood at 1.9 percent of the Gross Domestic Product (GDP). This percentage would have been notably lower than the 2.3 percent recorded in FY22.

- **R&D:** Expenditure breakdown in Research and Development (R&D) shows the highest allocations in sectors such as medical services, health, family welfare, sanitation, and agricultural research.

Quality of Expenditure: *The projected ratio of revenue expenditure to capital outlay (RECO) for the States is expected to decrease to 5.0 in FY24 from 6.0 in FY23 (provisional accounts)*

Debt: *The debt-GDP ratio of States declined to 27.5 per cent as at end-March 2023 from the peak of 31 per cent at end-March 2021*

Revenue dynamics and fiscal capacity of Indian states

- **Own Tax Revenue:** The proportion of States' own tax revenue (SOTR) has risen from 5.7 percent of GDP in FY04 to 6.9 percent of GDP in FY23.
- SGST has emerged as the primary source, succeeded by sales tax/VAT, excise duty, stamp duty and registration fees, and taxes on vehicles.
- There exists considerable regional disparity in SOTR, ranging from over 70 percent of total tax revenue in states like Haryana, Maharashtra, Telangana, Tamil Nadu, Gujarat, Karnataka, Kerala, and Punjab to less than 50 percent in Bihar and Jharkhand.
- Tax capacity: It is distinct from the actual tax collection, which depends on the ability of the government to exploit its tax capacity
- The realised tax revenue is less than the maximum (tax capacity)
- The tax effort of individual States is computed as the ratio between actual tax revenue and the corresponding tax capacity
- The tax effort of States ranges between 0.71 to 0.99 during the estimation period, with an average tax effort of 0.81
- Capital outlay and development expenditure are found to be positively associated with the tax effort, suggesting that an optimum use of the tax base can create the fiscal space to enhance productive expenditures

Tax Administration, Tax Compliance, Coverage and Rate Structure of States: Some Issues

- In India, the collection of various State taxes, such as stamp duty and registration fees, sales tax/VAT, excise duty on alcoholic beverages, and motor vehicles tax, faces significant technical inefficiencies.
- These inefficiencies are largely linked to the rate structure. For instance, stamp duty rates vary between 5-8 percent across States, compared to the international average of less than 5 percent. Higher tax rates result in increased transaction costs, encourage tax evasion, and disrupt urban land markets.
- The current structure of the Goods and Services Tax (GST), which consists of four tax slabs - 5 percent, 12 percent, 18 percent, and 28 percent - also contributes to complexity.
- Moreover, the *motor vehicle tax system in India lacks uniformity due to differing bases for computation and varying rates across States*, resulting in different tax burdens per vehicle in different regions.
- *Inter-state differences arise from the application of different tax rates based on vehicle categories, utilizing specific and ad valorem rates, and having multiple tax rates.*
- A significant portion of revenue arrears remains unsettled in courts and other appellate authorities, depriving States of potential revenues.

States' own non-tax revenue (SONTR)

- The contribution of SONTR to total revenue has consistently decreased over the past decade, remaining below 10 percent since 2010-11 (reaching 1.3 percent of GDP in 2022-23). Economic services serve as the primary source of non-tax revenue for States, constituting around 60 percent in 2021-22 and 2022-23.
- There is substantial disparity in own non-tax revenue collection among States. Mineral-rich states like Odisha, Chhattisgarh, and Jharkhand derive a

significantly higher share of non-tax revenue from mining royalties and mine premiums, exceeding 60 percent.

- In Goa, government non-tax revenue includes electricity charges collected from consumers due to electricity distribution being a government activity. Conversely, in most other states, power distribution is managed by power distribution companies (DISCOMs).

Non-tax revenue measures of states and suggested reforms

- Reform measures undertaken by State governments include inter alia, e-auction of mining leases, royalty revision across different segments of mining minerals, revision of the penal rates to curb secret mining and related activities, land monetisation, revision of water rates for industrial use, and improved financial management of the State public sector enterprises.
- With the upward revision of electricity tariffs by various States, the under-recovery has come down from Rs. 0.69/kWh in 2020-21 to Rs.0.22/kWh in 2021-22
- Smart and pre-paid metering in power distribution may help in further improving billing and collection efficiency, with a commensurate impact on lowering Aggregate Technical and Commercial (AT&C) losses
- For Social services user charges should at least recover the operation and maintenance (O&M) costs of infrastructure assets deployed for social services
- Proper pricing of water has also assumed importance in view of the fast depletion of groundwater levels and excessive usage/ wastage of water in many States An appropriate pricing of water - for example, volumetric water charges instead of charging a flat rate - would help in economising the use of water and promote environmental sustainability

Inter-governmental transfer

- Vertical fiscal imbalance in India is higher than in countries like Brazil and Canada with Indian States collecting 37 per cent of general government taxes while spending 64 per cent of total expenditure

- The composition of fiscal transfers to states is shifting: there's a reduction in the central share of taxes, an increase in grants, and a decline in loans from the central government.
- States' dependence on fiscal transfers, reflected in the share of transfers in total expenditure, increased sharply during the pandemic-period of FY21 and FY22 but it has moderated to 40 per cent in FY23
- The actual tax devolution to States has trailed the recommended share due to cesses and surcharges that are excluded from the divisible pool of Union taxes
- There has been an increase in the share of need-based parameters while both equity- and efficiency-based parameters have seen a decline in their weights
- The revenue collected by the Union government from cesses increased from 6.4 per cent of its gross tax revenue in FY12 to 17.7 per cent in FY22
- Due to increase in cesses and surcharges, the divisible pool has shrunk from 88.6 per cent of gross tax revenue in FY12 to 78.9 per cent in FY22 despite the 10 percentage point increase in tax devolution recommended by FCXIV
- The actual tax devolution to States hovered in the range of 3-4 per cent of GDP during the award period of FC-XIV and FCXV as compared with around 2.7 per cent during the previous three finance commissions
- Since the actual tax devolution hinges critically on the cesses and surcharges levied by the Centre, the States need to augment their own fiscal capacity and reduce dependence on transfers.
- Divisible pool of taxes as a percentage of gross tax revenue at 78.9% much lower compared to 90% in 2012
- The CSSs, which have received a major push from the Centre in the post COVID period, now account for around two-thirds of the total grants
- On the other hand, the Finance Commission grants constitute only around a quarter of the total grants from the Centre.
- Total grants as a percentage of GDP increased - 3.2% of GDP
- Composition as a percentage of GDP - 1.8 - CSS, 0.6 FC grants , 0.3 - other grants

- ❖ The FC-XV recommended grants-in aid amounting to Rs.10.3 lakh crore for the five year period 2021-26. Of this, 42.3 per cent were earmarked for local governments, while 29 per cent were revenue deficit grants. The actual transfers during the first two years of FC-XV are marginally lower than the recommended amount

Way forward

- ❖ OPS: If all the State governments revert to OPS from the National Pension System (NPS), the cumulative fiscal burden could be as high as 4.5 times that of NPS, with the additional burden reaching 0.9 per cent of GDP annually by 2060.
- ❖ Fiscal deficits exceeding 4 per cent of GSDP in FY24 as against the all-India average of 3.1 per cent. They also have debt levels exceeding 35 per cent of GSDP as against the all-India average of 27.6 per cent. Any further provision of non-merit goods and services, subsidies, transfers and guarantees will render their fiscal situation precarious and disrupt the overall fiscal consolidation achieved in the last two years
- ❖ Improvement in tax administration
- ❖ Asset monetisation: scale up their initiatives for asset monetisation in order to increase nontax revenue. Monetisation of assets unlocks their value, eliminates their holding cost and enables scarce public funds to be deployed into new projects, thus fast-tracking new infrastructure creation. State governments need to tap into their sizeable infrastructure asset base, with significant potential in roads, transport and power sectors. A comprehensive review of unutilised land assets and their conversion into revenue generating industrial estates or monetising them by outright sale would also help to mobilise revenues. Similarly, in the case of non-operational public sector undertakings (PSUs), States may expedite their liquidation to curb losses
- ❖ The use of modern technologies such as, Geographic Information Systems (GIS) and Drone Surveys may be utilised by the States for identifying and curbing illegal mining activities

- Revenue deficit grants: Currently, revenue deficit grants are disbursed to those States that are assessed to have high revenue deficits post tax-devolution. Such protected revenues could disincentivise the States from carrying out fiscal reforms. Going forward, the Finance Commissions could consider recommending an increased share of conditional transfers based on reforms, quality of expenditure and fiscal sustainability to harness healthy competition across States towards improving their economic performance
- Climate change mitigation: The Centre can introduce performance-based incentives for States that progress significantly towards climate goals. For instance, additional grants could be given to States that do well in reducing emissions or increasing renewable energy generation. Also, within the Scheme for Special Assistance to States for Capital Investment, a separate head for climate related investment projects can be considered.