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RBI Review of State Finances

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Key takeaways

- States have budgeted their consolidated gross fiscal deficit (GFD) at 2.8% of GDP in 2020-21. Although the RE for 2019-20 placed the GFD at 3.2%, provisional accounts released by the CAG indicate that this was achieved through large cutbacks on both revenue and capital expenditure to compensate for cyclical shortfalls in tax collections.
- In 2020-21, about half of the states have budgeted the GFD/GSDP ratio at or above the 3% threshold.
- The direction of possible revision is evident from the fact that the average for states presenting their budget before the outbreak of the pandemic is 2.4%, while that for the balance number of states that made post-outbreak budget presentation is 4.6% of GSDP.

2019-20: Revised Estimates and Provisional Account

- Despite lower revenue collection most states maintained their revenue spending closer to 2018-19 levels, albeit lower than budgeted levels, with a re-allocation in revenue spending.
- Committed expenditure also rose, particularly pension payments.
- Allocation of spending towards farm loan waivers went up in 2019-20.
- The reduction in capital spending vis-a-vis BE observed in 2017-18 and 2018-19 recurred in 2019-20 on account of lower revenue accretion and was mainly concentrated in the rural development and irrigation.
- During 2019-20 as per provisional accounts, all states cut capex not only against budgeted levels, but also vis-à-vis the previous year.

2020-21: Budget Estimates and Actual so far

In anticipation of a recovery of economic activity in 2020-21, states budgeted for higher tax revenue collection, with broad-based increases in all tax components. However, it is increasingly certain that the slump in economic activity due to COVID-19 led lockdown will adversely impact states' revenue collections.

- The major head under states' own tax revenue, viz., taxes on commodities and services would be impacted the most. SGST plummeted by 47.2% during Q1:2020-21 - sharper than the overall GST decline.
- During Q2, however, the decline moderated to 6.4%.
- Stamp duties, which are a major source of revenue under states' direct taxes, are also likely to witness a shortfall, consequent upon contraction in construction activity, reverse migration of labourers and social distancing norms.
- Furthermore, revenue specific measures, viz., extension of deadlines for payment of taxes to provide relief to businesses and citizens may further exacerbate the already worsening revenue situation of states.

Measures taken to increase revenue

- To garner some additional revenues during these unprecedented times, 22 states/UTs have hiked their duties on petrol and diesel, while 25 states/UTs have hiked duties on alcohol.
- The consequent rise in petrol /diesel prices is in the range of 60 paisa to Rs 8, while for alcohol, it is in the range of 10-120%, on an average basis.
- This is expected to provide a revenue gain in the range of 0.03 to 0.35% of GSDP.
- Petroleum and alcohol, on an average, account for 25-35% of the own tax revenue of states.

Transfers to states

Of the total revenue receipts of states, central tax transfers comprise 25 to 29%, while own tax revenues have a share of 45 to 50%. Given that a large shortfall in the divisible pool is highly likely in 2020-21, central tax transfers to states could fall by a significant margin.

- Revenue receipts are likely to be cushioned by revenue deficit grants, which compensate for deficits that prevail even after devolution, and the GST compensation cess, which states are stipulated to receive if their revenues fall below a threshold in any particular year (GST Compensation Cess Act, 2017).
    - It may be noted that with an increase in revenue deficit grants by Rs 44,340 crores in the additional supplementary demand for grants announced by the centre in September 2020 on top of the budgeted Rs 30,000 crore on February 1, 2020, it has released the full quantity of revenue deficit grants as recommended by the Fifteenth Finance Commission (FC-XV). Accordingly, the revenue deficit grants in 2020-21 are more than double the average of the previous few years.
    - As regards GST compensation cess, states have received the full GST compensation in the first three years of GST implementation. Unlike 2017-18 and 2018-19, for 2019-20, amount transferred to states was higher than collections during the year.
    - Nevertheless, the high uncertainty associated with the quantum of GST cess collections by the centre, coupled with ambiguity Rs 65,000 cess collections are expected, *the Centre has decided to borrow an additional Rs 1.1 lakh crore in tranches in H2:2020-21 to provide compensation to states for shortfall in their revenue in 2020-21 arising on account of GST implementation.* The amount so borrowed will be passed on to states as a loan, in lieu of GST compensation cess release, and will reflect as capital receipts of state governments, going into the financing of respective fiscal deficits.

Revenue Expenditure

- States have budgeted for reduction in revenue expenses in 2020-21 vis-à-vis 2019-20 RE, and a higher capital expenditure in 2020-21 vis-à-vis 2019-20 RE, mostly in social services under capital outlay.
- While higher spending is budgeted in education, water supply and sanitation, rural and urban development, *spending on energy and transport is expected to be curtailed.*
- Social sector expenditure has been increasing since 2018-19 and is budgeted to reach 8.0% of GDP in 2020-21. The pandemic has necessitated fiscal policy actions to boost aggregate demand. Alongside the centre, state governments have been proactive in undertaking policy measures to contain the impact of the pandemic.
- Quantifying the various kinds of policy measures, the fiscal stimulus works to about 0.3% of GDP

Capital outlays

Capital spending in India is not completely executed, however, and often falls short of the budgeted targets. States tend to cut back their capital expenditure by almost 0.5% of GDP, on an average, to meet fiscal deficit targets. A similar tendency can be expected in 2020-21, particularly since states have not been able to start much capex in H1 because of lockdown (in Q1) and monsoons (in Q2). As in revenue expenditure, one may see major re-adjustments and re-prioritisation as well. *While the obvious focus in H1:2020-21 seems to be on capex in health and education sectors in response to the pandemic*, other critical sectors like roads and construction may draw attention in H2.

To drive capex, centre also recently announced a special interest free 50-year loan to states for capital expenditure of *Rs 12,000 crore to be spent till March 2021, albeit it represents a small fraction of budgeted capex of Rs 6.5 lakh crores*

Trends in market borrowing

- On average, market borrowings financed slightly more than half of the consolidated fiscal deficit of states till 2016-17. Since 2017-18, however, the share of market borrowings has increased rapidly and is budgeted to reach close to 90% in 2020-21.
- As per 2018-19 actual, *states with GFD equal to or less than 3% of GSDP financed it mostly through market borrowings*. States with *GFD-GDP ratios of more than 3% have relied on other sources,* viz., withdrawal from public accounts like provident funds, deposit and advances, and cash withdrawals, being constrained by the provisions of Article 293 of the constitution.
- In a longer-term perspective, borrowing by states/UTs - gross and net - are fast catching up with those of the centre, with the drying up of all other sources of financing.
- While states *like Odisha and Haryana have been pragmatic in trying to meet their higher fiscal deficits by using their own rainy funds* without recourse to higher permissible market borrowings, there are states like *Gujarat and Punjab which have over-borrowed despite consolidation, with Uttar Pradesh being an extreme case* - it has borrowed above 20% of the budgeted amount, despite registering a fiscal surplus as against a budgeted deficit in 2019-20.

Market borrowings of states

Rs crore	2018-19	2019-20	2020-21 (First half of the year)
1. Andhra Pradesh	30,200.0	42,415.0	31,250.0
2. Arunachal Pradesh	719.0	1,366.0	428.0
3. Assam	10,595.0	12,906.0	3,300.0
4. Bihar	14,300.0	25,601.0	12,000.0
5. Chhattisgarh	12,900.0	11,680.0	2,000.0
6. Goa	2,350.0	2,600.0	1,500.0
7. Gujarat	36,970.7	38,900.0	19,780.0
8. Haryana	21,265.0	24,676.9	18,500.0
9. Himachal Pradesh	4,210.0	6,580.0	500.0
10. Jharkhand	5,509.0	7,500.0	-
11. Karnataka	39,600.0	48,500.0	29,000.0
12. Kerala	19,500.0	18,073.0	15,930.0
13. Madhya Pradesh	20,496.0	22,371.4	11,000.0
14. Maharashtra	20,868.9	48,498.3	48,500.0
15. Manipur	970.0	1,757.0	700.0
16. Meghalaya	1,122.0	1,344.0	800.0
17. Mizoram	-	900.0	442.0
18. Nagaland	822.0	1,000.0	500.0
19. Odisha	5,500.0	7,500.0	3,000.0
20. Punjab	22,114.7	27,355.0	12,110.0
21. Rajasthan	33,178.0	39,092.0	27,450.0
22. Sikkim	1,088.0	809.0	615.0
23. Tamil Nadu	43,125.5	62,425.0	48,000.0
24. Telangana	26,740.0	37,109.0	22,961.2
25. Tripura	1,542.8	2,928.0	400.0
26. Uttar Pradesh	46,000.0	69,703.0	13,500.0
27. Uttarakhand	6,300.0	5,100.0	2,500.0
28. West Bengal	42,828.0	56,992.0	22,000.0
29. Jammu and Kashmir	6,684.0	7,869.0	4,705.0
30. Puducherry	825.0	970.0	225.0
All States and UTs	4,78,323.5	6,34,520.5	3,53,596.2

Special dispensation for FY21

- For 2020-21, states had budgeted a gross borrowing of Rs 7 lakh crore. Under the AatmaNirbhar Package in May 2020, states can increase their borrowing limits from 3% to 5% for 2020- 21. *This is expected to provide extra resources of Rs 4.28 lakh crore.*
- While the increase from 3 to 3.5% of GDP is unconditional, which states can access after suitable revision of their FRLs (many states have promulgated ordinance to this effect) the balance increase in market borrowing was initially made conditional.

- After the October GSTC Council meeting, states which benefit from the special window could get this additional 0.5% borrowing unconditional. This is, however, expected to have a limited impact on the fiscal deficit of state governments that are likely to borrow a considerably lesser amount from the additional borrowing facility of 2% of GSDP under the Aatma Nirbhar Package.
- Overall, they may be able to utilise only half of the additional borrowing given to them - conditional and unconditional on an average. With borrowings financing about 90% of states' fiscal deficit, on an average, borrowing limits under Article 293 (3) act as soft constraint.
- Thus, from the financing side, *states' combined GFD-GDP ratio is likely to remain around 4% with a bias tilted to the upside, higher than the budgeted 2.8% of GDP albeit with state-wise variations.*

Cost of borrowings

- The weighted average (cut-off) yield (WAY) of SDLs had been rising since 2016-17 till 2018-19, although it moderated in 2019-20 to 7.24%, about 108 bps lower than in 2018-19.
- After significant moderation in Q1:2020-21, SDL yields and spreads have been picking up in Q2. The average inter-state spread on SDLs of 10-year maturity (fresh issuance) was higher at 9 bps in H1:2020-21 (4 bps in H1:2019-20).
- The Policy Statement, October 2020 has allowed open market operations (OMO) in SDLs, which may improve secondary market liquidity and lower their spreads over corresponding G-secs.

Cash balances

States have been accumulating sizeable cash surpluses in recent years in the form of Intermediate Treasury Bills (ITBs) and Auction Treasury Bills (ATBs), involving a negative carry of interest rates and warranting improvement in cash management practices going forward. There is, however, evidence of utilisation of cash balances on the part of many states in H1:2020-21, notably for ITBs.

As of March 2018, such investments were Rs 2.13 lkh crore which came down to Rs 1.96 lkh crore in March 2019. As of March 2020, they were Rs 1.88 lkh crore and Rs 1.83 lkh core on September 2020.

WMA

The ways and means advances (WMA) limits of states was reviewed by an Advisory Committee in 2016 and it recommended the limit of Rs 32,225 crore for all states/UTs together. RBI decided on April 1, 2020 to increase states' WMA limit by 30% from the existing limit for all states/UTs and this was increased further by 60% over and above the level as on March 31, 2020, extended for a further period of 6 months till March 31, 2021. Furthermore, the number of days for overdraft (OD) has been increased, effective April 7, 2020, till September 30, 2020 and further extended till March 31, 2021.

16 states availed the Special Drawing Facility (SDF) in 2019-20, while 13 states resorted to WMA and ten states availed OD. During 2020-21 so far, utilisation of WMA has shown significant rise.

Reserve funds

Maintaining reserve funds is a best practice in debt management strategy. State governments maintain the Consolidated Sinking Fund (CSF) and the Guarantee Redemption Funds (GRF) with the Reserve Bank as buffer for repayment of their future liabilities. States also avail the SDF at a discounted rate from the Reserve Bank against incremental funds invested in CSF and GRF. As at end-March 2020, *23 states and one UT were members of the CSF scheme, while 18 states were members of the GRF* scheme. Since then, one more state has joined the CSF.

Debt

Outstanding debt continued to grow in double digits, albeit lower than in the years of UDAY implementation. State-wise data reveal that the debt-GSDP ratio is expected to increase for 13 states. For 19 states, this ratio is expected to exceed 25% in 2020-21 which may force curtailment of capital expenditure. The ratio of interest payment to revenue receipts, an indicator of debt sustainability, has been declining in recent years, although it remains higher than the threshold prescribed by the fourteenth Finance Commission.

Outstanding liabilities to GSDP

State/UT	2018	2019	2020 (RE)	2021 (BE)
1. Andhra Pradesh	28.9	30.6	31.8	32.7
2. Arunachal Pradesh	31.1	34.3	42.1	41.7
3. Assam	17.4	18.9	21.5	23.7
4. Bihar	33.5	31.9	31.5	30.8
5. Chhattisgarh	20.1	22.7	26.3	27.1
6. Goa	26.9	28.0	28.1	28.1
7. Gujarat	20.2	19.9	19.6	18.8
8. Haryana	25.7	25.6	25.2	24.9
9. Himachal Pradesh	36.9	35.3	36.0	35.7
10. Jharkhand	28.8	28.2	28.2	27.9
11. Karnataka	18.1	18.5	19.2	20.5
12. Kerala	30.9	31.2	30.5	30.3
13. Madhya Pradesh	23.9	24.1	25.3	29.4
14. Maharashtra	18.2	16.7	16.6	16.7
15. Manipur	37.1	37.5	37.5	34.7
16. Meghalaya	34.4	33.9	32.8	33.4
17. Mizoram	40.3	39.1	39.5	40.9
18. Nagaland	42.5	42.7	38.7	38.2
19. Odisha	23.4	21.5	22.3	23.1
20. Punjab	41.5	40.3	40.0	38.7
21. Rajasthan	33.7	33.1	33.7	34.5
22. Sikkim	22.8	23.8	23.7	23.1
23. Tamil Nadu	22.3	24.6	24.5	24.5
24. Telangana	21.3	22.1	22.6	22.8
25. Tripura	30.6	30.3	31.3	30.9
26. Uttar Pradesh	35.4	34.0	33.9	33.1
27. Uttarakhand	23.8	24.2	24.7	24.8
28. West Bengal	38.1	37.1	35.7	34.7
29. Jammu and Kashmir	48.8	50.5	51.3	49.3
30. NCT Delhi	0.5	0.4	0.3	0.4
31. Puducherry	22.0	23.5	21.9	21.5
All States and UTs	**25.1**	**25.2**	**26.3**	**26.6**

Interest to revenue receipts

	2018-19 (A)	2019-2 (RE)	2020-21 (BE)
1. Andhra Pradesh	13.4	14.8	12.6
2. Arunachal Pradesh	3.2	3.9	3.5
3. Assam	6.1	5.2	6.3
4. Bihar	7.6	7.3	7.0
5. Chhattisgarh	5.6	6.4	7.0
6. Goa	11.8	11.2	11.6
7. Gujarat	14.8	15.1	14.7
8. Haryana	20.6	20.8	20.2
9. Himachal Pradesh	13.0	14.1	12.8
10. Jharkhand	8.2	7.1	7.5
11. Karnataka	9.3	10.5	12.3
12. Kerala	18.0	18.6	17.3
13. Madhya Pradesh	8.4	9.3	12.1
14. Maharashtra	12.2	11.0	10.2
15. Manipur	5.5	3.9	3.2
16. Meghalaya	6.8	5.2	5.5
17. Mizoram	4.1	3.7	3.8
18. Nagaland	6.7	7.4	6.6
19. Odisha	5.8	5.8	5.8
20. Punjab	26.2	23.8	21.7
21. Rajasthan	15.7	15.2	14.7
22. Sikkim	7.3	7.6	7.0
23. Tamil Nadu	16.6	16.5	16.6
24. Telangana	12.4	13.0	10.2
25. Tripura	8.5	8.3	7.4
26. Uttar Pradesh	9.7	9.3	9.0
27. Uttarakhand	14.3	14.5	13.9
28. West Bengal	19.8	19.2	18.3
29. Jammu and Kashmir	10.2	5.3	7.9
30. NCT Delhi	6.7	5.3	5.5
31. Puducherry	11.0	10.0	10.1
All States and UTs	**12.2**	**11.9**	**11.7**

Contingent Liabilities

Along with higher borrowings and the attendant servicing costs, debt sustainability of states is vulnerable to risks arising out of potential realisation of contingent liabilities in the form of guarantees, which have increased post COVID-19. As part of first tranche of the centre's Aatma Nirbhar Bharat Package announced in May 2020, emergency liquidity infusion of Rs 90,000 crore for cash-stressed power distribution companies (DISCOMs) was announced against state government guarantees, thus, adding to their contingent liabilities *for 2020- 21 by about 0.42% of GDP.*

It may be noted that historically, any large accretion to states' outstanding guarantees has, in general, been followed by an increase in debt. State guarantees, which increased prior to 2014, fell sharply thereafter, primarily driven by subsuming of power sector guarantees into state government liabilities under the UDAY programme. However, since 2017-18, net accretion to guarantees has seen a significant jump. This could be an early sign of future fiscal risks. *Although a cap/ limit amounting to about 2% of GSDP is considered optimal as per State Acts, there is no strict adherence to it.*

The financial position of DISCOMs is expected to weaken further in 2020-21 as COVID-19 related lockdown has severely impacted power demand, particularly in the lucrative industrial and commercial segments, while their cost structure is rigid due to minimum commitments for power offtake in long-term Power Purchase Agreements (PPAs). Structural issues remain to be addressed.

While Union Government announced a liquidity support of Rs 90,000 crore for DISCOMs which may help tide over immediate liquidity concerns, another round of bailouts of loss-making DISCOMs seems imminent in the aftermath of the crisis, imparting downside risks to state finances

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