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A Deep Dive into State Budgets in India[§]

ABSTRACT Over the past six years state government budgets have increased sharply, and states now collectively spend 87 percent more than the Union Government. In this period, not only has their expenditure as a share of India's GDP increased from 14 percent to 18 percent, but they are, as a group, now nearly equal to the Central Government in terms of their annual borrowing from the bond markets.

Most of the available research on state budgets focuses on aggregates like the total fiscal deficit and total borrowing requirements, or comparisons of states on standard high level ratios like own revenues as a share of GDP. While this sufficed when states were fiscally smaller, we need to step up analysis and scrutiny of state budgets as well as their regulation.

In this paper we dig deeper into state budgets, looking at the sources that have driven this increase in expenditure, analyzing expenditure trends, and addressing, for example, the following questions: Can revenue expenditure be more productive than capital expenditure for some states? How has the greater devolution under the 14th Finance Commission affected social sector spending? We explore differences in the states' revenue sources, their creativity in exploiting their tax opportunities, and the extent of their dependence on Central transfers. We find salary expenses to be mostly in control, but a worrying increase in the share of expenditure for pensions. Concerns around the states' fiscal profligacy need to be tempered with the realization that the states' fiscal deficits cannot rise without the Centre's explicit approval: we explore the reasons behind and the impact of the spurt in farm loan waivers.

We also dig into the impact of major changes like the start of GST and the target of 20 percent debt to GDP by 2023 prescribed by the Fiscal Responsibility and Budget Management (FRBM) Review Committee for state governments.

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As states' bond issuances start equalling the Centre's, their borrowing calendar needs greater attention to avoid market volatility. We find growing differences between the budgeted, revised, and final numbers, with strong evidence of apathy being the primary driver: such flaws may have been ignored in the past given their small size, but these now warrant scrutiny and rectification.

Keywords: State Budgets, Public Finance, India, Fiscal Policy

JEL Classification: H7, H8

1. Introduction

Despite the rising importance of state government budgets in the economy over the past six years, there has been no comprehensive analysis of either changes at an aggregate level or the differences between states on various parameters like indebtedness, dependence on Central transfers, flexibility in expenditure, and the efficacy of their spending on various heads. A big reason for this is the paucity of detailed data, particularly as the only comprehensive source is the Reserve Bank of India's (RBI) compendium of state budgets. As this compendium is published only 14–15 months after the presentation of budgets, any analysis based on this becomes backward-looking. Further, significant differences between budget estimates and what actually transpires mean that accurate data is only available with a lag of more than two years.

Over the past three years, we have been publishing detailed budget analyses for the larger states, poring over budget speeches by state finance ministers and standardizing state level budget data into comparable categories. This not only allows us to be almost a year ahead of publication of the RBI's compendium but has also led to the discovery of several nuances (like large differences between “revised” budget deficits and what is delivered finally) that are very important for understanding the trends and patterns underneath the publicized headline numbers.

In Section 2, we discuss the steadily rising importance of state budgets on several fronts. Growth in their aggregate expenditure has outpaced that by the Central Government for each of the last seven years (starting FY2012), and their combined spending is now 18 percent of GDP versus just 14 percent in FY2012. Further, state tax collection as a share of GDP has risen meaningfully over the past decade. Lastly, while the Central fiscal deficit ratio has nearly halved to just above a 3 percent level over this period, the States' ratio has stayed in the 2–3 percent range, and the size of their absolute fiscal deficits is now becoming comparable to that of the Centre. This has also meant that the state government bond (State Development Loans, or SDLs) issuance every year is comparable to that of the Centre, and their calendar is now very important for the bond markets.

In Section 3, we analyze some major expenditure heads for state governments, starting with whether revenue expenditure is as bad as it is made out to be, particularly in under-sized governments. As state governments shoulder the bulk of the responsibility of providing government services, their spending is spread over a wide range of categories. We analyze some of the more salient ones, like interest payments and the debt burden of states, salaries and pensions, and comment on differences between states on spending on education (revenue expenditure) as an example. We end the section with an analysis of budgeting accuracy (rather, its absence).

In Section 4, we assess the impact of some significant framework-level changes that are occurring now: GST, which subsumes 40 percent of all of India's taxes; the recently triggered wave of loan waivers across states; and the implications of the Fiscal Responsibility and Budget Management (FRBM) Review Committee's recommendations for debt to GDP levels for state governments (Singh et al. 2017).

Following are explanations of nomenclature and some abbreviations used in the paper:

- There are at least four versions of each year's budget. Budgeted Estimates (BE) are presented 1–2 months before the financial year starts; Revised Estimates (RE) are published when the next year's budget is being presented (governments at this time have actual data for 9–10 months of the year, and use projections for the remaining 2–3 months), Provisional (available 1–2 months into the next financial year), and Final (after all the data becomes available). As India's financial year ends on 31st March, FY2018 stands for the fiscal year ending March 31, 2018; the suffix 'b' for a year indicates BE; 'r' indicates RE; and numbers without a suffix indicate the provisional or the final numbers.
- As large numbers get mentioned frequently, we shorten trillion to 'tn', billion to 'bn', and million to 'mn'.
- YoY stands for Year-on-Year: a measure compared to a similar one from the previous year.
- CAGR stands for the Cumulative Annualized Growth Rate.
- To make charts more readable, we use two-letter abbreviations for states: their mapping is in the Appendix.

2. Rising Fiscal Importance of the States

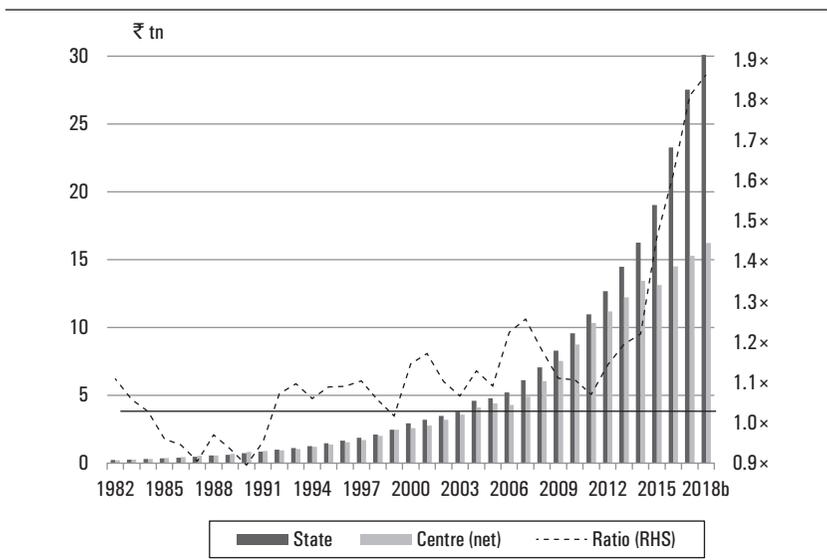
Growth in aggregate expenditure of state governments has outpaced that of the Central Government for each of the last seven years (starting FY2012). In this analysis, to avoid double-counting, we subtract from the Central

Government's spending the transfers to the states where the Centre does not control the last-mile delivery: we thus look at "net" central spending in these comparisons. These transfers are mainly grants under various heads, including some Centrally Sponsored Schemes (CSS) like the Sarva Shiksha Abhiyan (SSA).

Such a sustained period of faster growth in state spending has not been seen in the past several decades. This has been supported by four important changes: (a) even before the 14th Finance Commission-recommended 42 percent devolution of taxes was implemented (Reddy et al. 2015), the Central Government had started combining programs that focused on state subjects, and giving state governments more discretion; (b) the 14th Finance Commission's recommendations increased state governments' control; (c) state governments' own tax revenues have continued to grow; and (d) a steady increase in nominal GDP has created more fiscal space for states even though their aggregate fiscal deficit ratio has remained below the mandated 3 percent of GDP, even as a sharply shrinking deficit ratio for the Centre has kept the absolute Central fiscal deficit broadly unchanged.

As a result of these trends, from spending 6 percent more than the Centre in FY2011, the states are budgeted to spend 87 percent more than the Centre in FY2018b (Figure 1). Even adjusting for the Ujwal DISCOM Assurance Yojana (UDAY), where state governments took on the State

FIGURE 1. States Now Spend 1.87× the Centre's Net Spend



Sources: RBI, Budget documents, Credit Suisse estimates.

Electricity Board debt, the related expenses of ₹732 bn and ₹638 bn in FY2016 and FY2017, respectively, expenditure growth was in the high teens in the last three years.

However, the growth in expenditure has slowed down in FY2018b to just 9.3 percent over FY2017r, the lowest in more than a decade. While this is still higher than the growth budgeted by the Centre, it suggests that the forces that were driving the divergence are now waning, and the gap between the Central and state expenditures should be plateauing going forward.

The main reasons for this slowdown appear to be a smaller increase in Central transfers and a drop in the fiscal deficit: these offset the increase in own revenue growth. After three years of sharp increases in Central transfers, when these rose by ₹1.4–2.4 tn each year, the increase in FY2018b would be only ₹1.1 tn; on the higher base, the growth therefore appears lower. The budgeted decline in the absolute fiscal deficit for FY2018b is also intriguing, coming as it does at a time when the popular consensus is of profligate states undoing the fiscal discipline of the Centre. The budgets for the states do not yet incorporate the loan waivers announced in the past few months, but as we demonstrate in Section 4.2, the impact of those is likely to be spread out over several years.

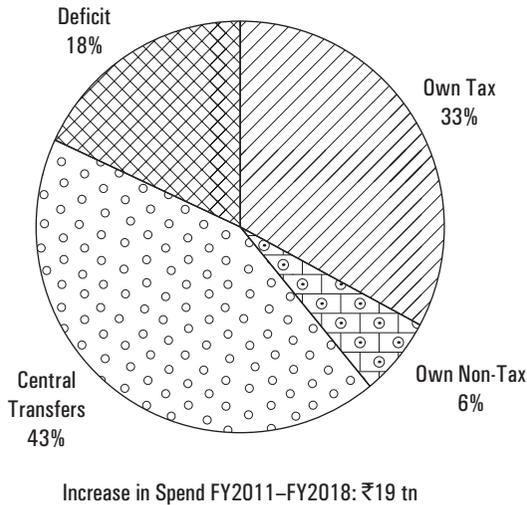
We discuss all the themes in detail in the following sub-sections.

2.1. Pickup in Central Transfers

Of the ₹19 tn increase in State government expenditure between FY2011 and FY2018b, 43 percent came from the rise in Central transfers (Figure 2). These consist of two parts: a direct share of Central taxes, and grants from the Centre.¹ While the first part comprises untied funds, meaning that the states have complete discretion in spending them, the grants generally come with pre-conditions, mostly about the desired areas of spending, but often also necessitating matching contributions from state governments.

As has been well discussed, the impact of the 14th Finance Commission was very significant in the sharp jump in the share of Central revenues directly transferred to the States. While the 11th to the 13th Finance Commissions had raised the proportion in increments of 50 to 150 basis points (bps), moving from 29 percent to 29.5 percent in the 11th, to 30.5 percent in the 12th, and to 32 percent in the 13th, the 14th Finance Commission

1. Central transfers to states take many forms: there are Centrally Sponsored Schemes (CSS), special grants to the North-Eastern states and Union Territories, Finance Commission-mandated transfers for specific purposes including for revenue deficit states, and other schemes. For brevity, we have loosely combined them into ‘grants’.

FIGURE 2. Sources of Funds for Rise in Expenditure during FY2011–FY2018

Sources: RBI, Budget documents, Credit Suisse estimates.

raised it to 42 percent in one go. To be clear, however, this was also accompanied by some reduction in grants to states, and the total transfers did not rise by that quantum.

In FY2018b, growth in the Central Government's gross tax revenue is also slowing down, from 17 percent each in FY2016 and FY2017r to just 12 percent in FY2018b, as the boost from the surge in excise duties on petroleum products as well as the increase in service tax rates is now in the base. This is reflected in the slower growth in transfers to the states as well. Further, whereas the grants to states, where the Centre holds some discretion in annual allocations to states, had increased by ₹540 bn in FY2017r (a growth of 16 percent over FY2016), in FY2018b, the growth is only ₹282 bn (a growth of 7 percent over FY2017r). This decline appears to be mostly in the grants to North-Eastern states and in the Revenue Deficit grants: the latter are issued as per the instructions of the 14th Finance Commission. These declines offset the increases in grants under the CSS.

As one can expect, states where Central transfers form a large part of the revenue receipts are budgeting for slower growth in spending in FY2018b. The outliers to this trend are Telangana and Andhra Pradesh on the higher side, and Maharashtra and Tamil Nadu on the lower side. Both Telangana and Andhra Pradesh are to receive special funds from the

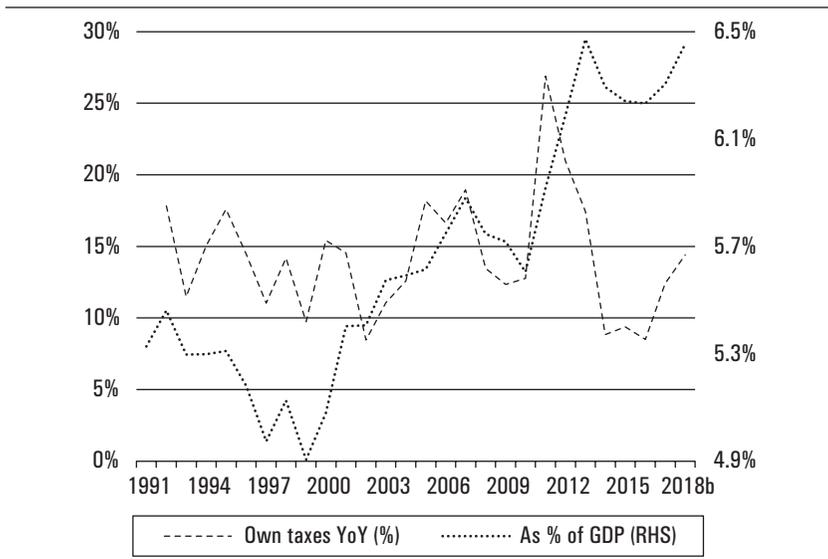
Centre due to promises made at the time when Telangana was carved out of Andhra Pradesh, for example funding for the Polavaram irrigation project. Maharashtra was budgeting for a sharp decline in the fiscal deficit ratio from 2.0 percent in FY2017r to 1.5 percent in FY2018b before the recently announced loan waivers, which explains its low expenditure growth. For Tamil Nadu, a ₹228 bn UDAY-related spend in FY2017r elevated the base: adjusted for that, the growth would be 11 percent YoY.

2.2. Growth in Own Receipts

The ability to spend more is not all due to the Centre delegating more responsibility: growth in own taxes has funded a third of the ₹19 tn increase in the states’ aggregate incremental expenditure between FY2011 and FY2018b (Figure 2) state taxes as a share of GDP have risen quite sharply from the bottom of 4.9 percent in 1999 to 5.9 percent by FY2011, and further to a budgeted 6.5 percent in FY2018b (Figure 3). The increase from 2009 onwards is attributed to the lagged effects of VAT implementation (Viswanathan 2016), which started in 2005 but was implemented by a few large states some years later, and then took a few years to stabilize.

A less well-documented fact is that while initially all the states started with the standard VAT rate of 12.5 percent, over time this increased to

FIGURE 3. States’ Own Taxes Have Risen as % of GDP



Sources: RBI, Budget documents, Credit Suisse estimates.

TABLE 1. Changes to Standard VAT Rates for Some of the Larger States (in %)

<i>Financial Year</i>	2009	2010	2011	2012	2013	2014	2015	2016	2017
MH	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	13.5
UP	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
TN	12.5	12.5	12.5	14.5	14.5	14.5	14.5	14.5	14.5
KA	12.5	12.5	13.5	14.0	14.5	14.5	14.5	14.5	14.5
GU	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0

Source: Sales tax departments of various states.

Notes: 1. The acronyms for the states given in the table are expanded in the Appendix to this paper.

2. The numbers marked in bold signify tax rates after an increase.

14–15 percent in most states. Karnataka, for example, raised the standard rate from 12.5 percent to 13.5 percent in 2011, to 14 percent in 2012, and to 14.5 percent in 2013 (as also the concessional VAT rate from 4 percent to 5 percent); Tamil Nadu raised it to 14.5 percent in July 2011. Table 1 shows the rate changes for some of the larger states.

In the last two decades, aggregate tax to GDP in India has also increased, and the states' share of aggregate tax collection in India has ranged between 33 percent and 40 percent over this period. Between the advent of Central Government reforms in 1991 till 2002, as the Central Government rationalized tax slabs as well as rates, while the states did not, the states' share had increased to over 40 percent of the overall taxes. But then as Central tax revenues surged, driven among other things by a sharp improvement in corporate profitability, their share fell below 33 percent, bottoming in FY2008. The ratio increased again to nearly 39 percent, as VAT implementation (and the rate increases that followed) boosted state taxes, and Central taxes did not grow as fast (due to weaker corporate profitability as well as tax cuts effected to boost the economy in FY2009). In recent years, that is, FY2016 and FY2017, higher excise duties on petroleum products and the rise in service tax rates have caused this ratio to dip back to 36 percent.

Looking at state-level trends, it is clear that in the five-year period between FY2011 and FY2016 (the last year for which the final figures are available: budgeted and revised numbers are not as trustworthy) the tax to Gross State Domestic Product (GSDP) remained within a range for most states, like it did for the states' aggregate tax take. However, there were a few exceptions: states like Karnataka and Tamil Nadu saw their ratios drop sharply during the period, but this was either due to GDP revisions (Karnataka's FY2017 GDP was 65 percent higher than that in FY2016),

or rapid GSDP growth (in Tamil Nadu) without a concomitant increase in taxes. On the other hand, the own tax to GSDP ratio went up for states like Jharkhand, Bihar, and Rajasthan.

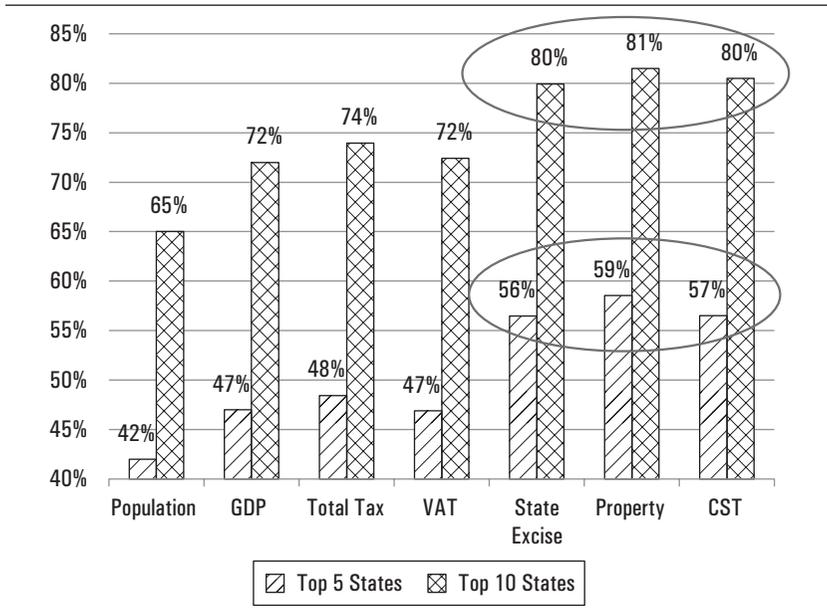
2.2.1. SALES TAX/VAT REMAINS THE DOMINANT SOURCE OF TAX REVENUES

State sales tax, also called Value-Added Tax (VAT), remains the dominant source of tax revenues for state governments, accounting for 60 percent of the ₹10 tn in taxes collected by them in FY2017b. Property Taxes (stamp duty, registration fees) and State Excise (i.e., manufacturing taxes on alcohol production) are 12 percent each of the overall taxes, and there are minor contributions from taxes on vehicles (5 percent: road tax), CST (4 percent), Electricity (3 percent) and Others (4 percent).

The share of non-VAT taxes in the states' own tax receipts has been falling slowly but steadily over the last three decades. From 42 percent in 1991, it has fallen to about 36 percent in FY2017b; the decline since FY2011 has been about 2 percentage points. There is a cyclical element in some non-VAT taxes like property taxes, but that can only explain weakness in a few years: the decline, on the other hand, has been surprisingly steady and long-drawn. A possible reason is that states have been lax in exploiting non-VAT sources of tax revenues.

This hypothesis is supported by the fact that non-VAT taxes are much more concentrated in their state-wise distribution among the top five and top ten states than VAT collection, overall tax collection and population. The top five and ten tax collecting states account, respectively, for 42 percent/65 percent of the population, 47 percent/72 percent of the GDP and 47 percent/72 percent of the VAT collections, but for State Excise (i.e., alcohol manufacturing taxes), Property Taxes and CST, these ratios are 10–12 percentage points higher at 56–59 percent and 80–81 percent, respectively (Figure 4). Moreover, the sets of states in the top five and top ten among the non-VAT taxes are also different.

There are some natural constraints of course. In stamp duty/registration tax collections for example, while there are (sometimes stark) differences in rates across the states as well, states that have more populous cities have a natural advantage in generating revenue from this source. As an extreme example, Bihar, which is just 11 percent urban, cannot, even if it wanted to, generate as much property tax as say Tamil Nadu, where 48 percent of the population lives in urban areas. The existence of several large cities like Mumbai, Pune and Nagpur in Maharashtra increases its tax potential (21 percent of all real-estate taxes), and the same holds true for Uttar Pradesh (14 percent: NOIDA and Ghaziabad are satellite towns

FIGURE 4. Non-VAT Taxes Are More Concentrated among a Few States

Sources: RBI, Budget documents, Credit Suisse estimates.

of New Delhi), Tamil Nadu (8 percent: Chennai), Karnataka (7 percent: Bengaluru), Gujarat (8 percent: Ahmedabad) and West Bengal (6 percent: Kolkata) as well.

Similarly, the stronger manufacturing-led economies of Gujarat, Maharashtra, Tamil Nadu, Karnataka and Haryana make them dominant in CST collections. In the GST regime, however, these “export taxes” (levied on goods manufactured for sale in other states) get abolished, however.

The states’ laxity in generating tax revenues is also visible in the over-reliance on petroleum products and alcohol in VAT collections: 29 percent of VAT in FY2014 came from petroleum products, and another 11 percent from alcohol (the number for alcohol is an approximation, as only Tamil Nadu discloses it separately). This was in addition to excise duties on alcohol that contributed 10–20 percent of all taxes for several states in FY2017b (12 percent for all the states put together). Some states levy very high tax rates on alcohol and in states like Kerala, nearly all sales must pass through state-owned enterprises. These drive significant mark-ups, and then the booked profits are passed on to the state government as dividends. This is the reason why states have been reluctant to allow alcohol into GST, and also unwilling to set GST on petroleum products.

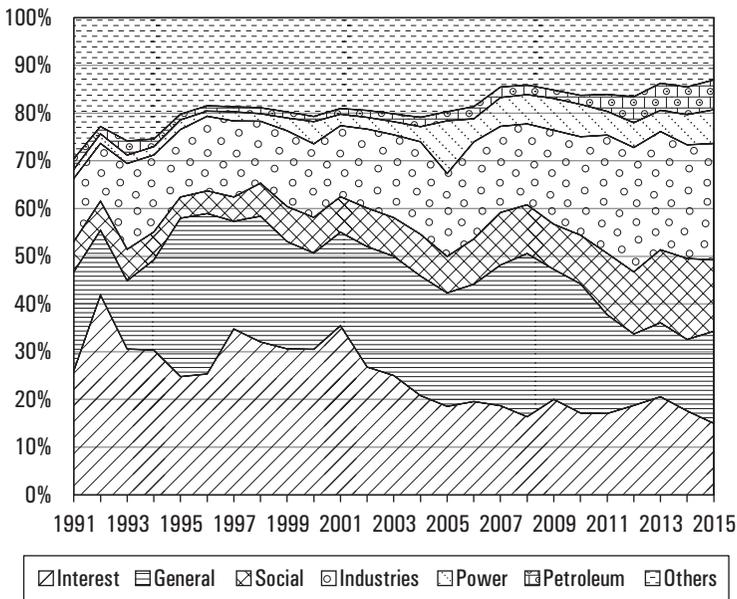
Thus, there appears to be significant unexploited potential for tax collection even in the taxes administered by state governments.

2.2.2. SHARE OF NON-TAX REVENUES STAGNATING AFTER A STEEP FALL, BUT OF BETTER QUALITY

Worryingly, states’ own non-tax revenues have grown slower than taxes, and have fallen from 18 percent of all revenue receipts in 1995 to just 8 percent now. From being 2.1 percent of GDP in FY1995 and 1.6 percent in FY2008, they just add up to 1.2 percent of GDP in FY2018b. This is higher than the low of 1.1 percent in FY2012 but still indicates an inability to generate other forms of revenue.

However, an analysis of the split of non-tax revenues provides some comfort. Interest income used to be a dominant source of non-tax income for state governments, but has come down significantly (Figure 5). After 2005, non-tax receipts were also boosted by some incentives given to states for fiscal correction, as part of the 12th Finance Commission grants. On the other hand, income from sources like industries, power, and petroleum have picked up, and that from forestry has declined in relevance. In recent years some states have also started to push for revenue generation from land: for example, Telangana had budgeted Rs 82 bn from land sales to

FIGURE 5. Share of Non-tax Receipts over Time



Sources: RBI, Budget documents, Credit Suisse estimates.

industry in FY2017, even though court cases slowed down the process, and there was significant revenue slippage (Telangana Budget Speech 2017). In states like Maharashtra such revenue generation has been commonplace, but mostly within urban centres to fund the city government (e.g., in the Bandra Kurla Complex in Mumbai). The administration of Jaipur (capital of Rajasthan) has also had some success in generating revenues through such means.

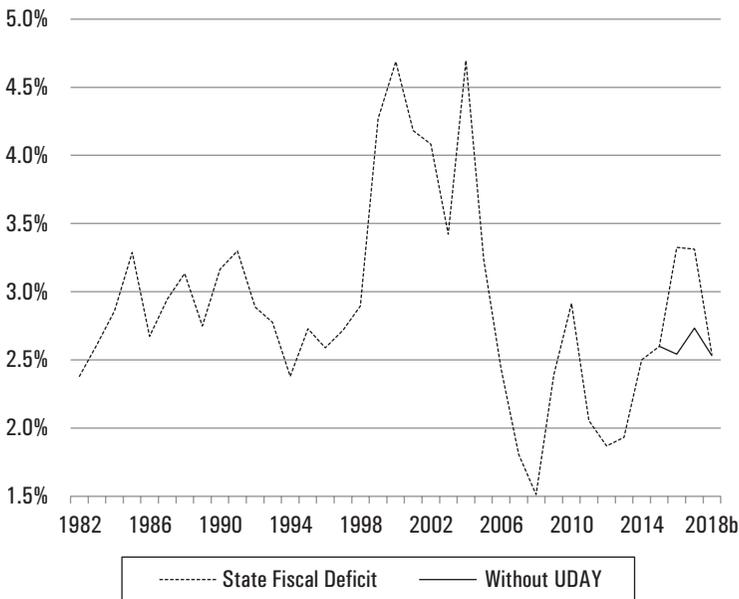
2.3. The Trend of State Deficits Determined Not by States but by the Centre

There has been much concern, if not alarm, recently on the profligacy of state governments undoing the fiscal contraction at the Centre. While the pick-up in state fiscal deficit ratios in the past six years has indeed slowed down improvement in the general government deficits, the concern gets exaggerated by two factors: the first being that FY2011 saw among the lowest ratios ever recorded for states and so is not the best starting point, and the second that UDAY-related borrowing drove the headline deficits higher. Adjusted for UDAY, aggregate state deficits have been in the range of 2.5–2.7 percent of GDP in the last five years, and well within the 3 percent range prescribed for them. This is despite some of the states starting to use the 50 basis points (bps) of extra fiscal room available to them if their debt to GSDP ratio and their interest expenses are within specified limits.

However, the reality is far less worrying, and the critical commentary shows a lack of awareness of how state deficit targets are determined and by whom.

As per Article 293(3) of the Constitution of India, state governments that are indebted to the Central Government (or have loans guaranteed by the Centre) must seek its consent before raising further borrowings. As all states currently have outstanding loans to the Centre, the Central Government effectively decides the fiscal deficit for the states. This situation is likely to persist at least till the middle of the next decade, when some of the Central debt issued around the debt restructuring of 2005–06 starts to mature. Even after that, it is possible that states may have loans (e.g., from multilateral agencies) that have Central guarantee; this could extend the period for which this clause is operative. As per the recommendations of the 14th Finance Commission, the Centre is already seeking legal advice on retention of this control.

In this context, the movement of the aggregate fiscal deficit ratio of the state governments (Figure 6) is easier to understand.

FIGURE 6. State Deficits up from Lows, but under Control, and Are Likely to Stay That Way

Sources: RBI, Budget documents, Credit Suisse estimates.

The ratio declined sharply between FY2005 and FY2010, the period governed by the 12th Finance Commission, which had recommended that the states keep their deficits within 3 percent of their respective GSDPs for the following five years (so that the aggregate remains within 3 percent of GDP). But there were two problems:

1. The Commission had projected the states' nominal GSDPs during 2005–10 at 12 percent per annum, using FY2005 GSDP as the base. The Centre set the borrowing targets for states based on this GSDP projection, and thus capped the states' fiscal deficits. However, the lowest nominal growth seen in this period was 13 percent in FY09, and India's nominal GDP grew at an average of 15 percent between FY2005 and FY2010. With the numerator (i.e., the absolute fiscal deficit, defined by borrowing targets) assuming lower growth and the denominator growing much faster, the fiscal deficit ratio plummeted. This was not out of any intent to consolidate fiscally to the levels that were reached. For some states like Haryana that grew

faster than the national average, the reduction in the deficit ratio was dramatic.

2. When fixing the borrowing targets, the GSDP is measured at factor cost while the national GDP is measured at market prices, which is generally higher as it includes indirect taxes and excludes subsidies. As a result, a 3 percent limit on each of the state GDPs at factor cost comes out to be a lower ratio when we take it versus national GDP. The 12th Finance Commission noted the need to use GDP at market prices but they maintain status quo for the lack of a readily available practical alternative. The 13th Finance Commission had also noted the absence of alternatives.

To fix the first problem, the 13th Finance Commission recommended that for calculation of the borrowing target, GSDP projections be made every year, using the previous year's base, instead of projecting for five years in one go. The result was visible in the rise of aggregate state deficit ratios after 2011.

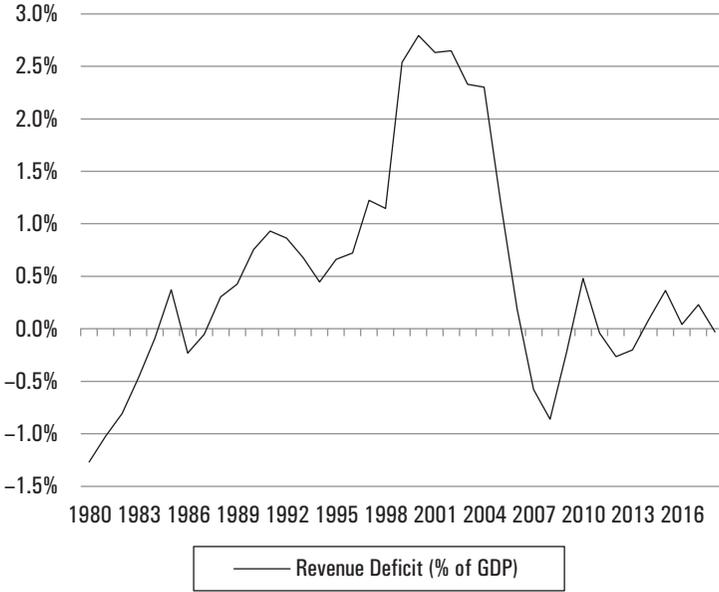
An additional measure of state fiscal health is the revenue deficit ratio. This had reached worrying levels around the late 1990s, particularly as some states appeared to get caught in a debt trap, with very high interest costs. The 12th Finance Commission had introduced a debt waiver incentive dependent on revenue deficit improvement by states, and also required them to enact their respective FRBM Acts. All states (except Sikkim and West Bengal, which did so in 2010) passed the FRBM legislation between September 2002 (Karnataka) and May 2007 (Jharkhand). Partly due to the very conservative formulaic fiscal deficit target, and partly due to the FRBM legislation, this deficit did come down substantially, and is still close to zero in aggregate (Figure 7).

2.4. States Now a Much Bigger Part of the Bond Market Than Earlier

One trigger of negative commentary is when financial markets press the panic button: bond traders have been spooked by the rising share of SDLs, that is, bonds issued by state governments to fund their deficits in overall government bond issuance (Figure 8). While this is in no way surprising, as the Central deficit ratio has halved and starts to approach the states' ratio, their borrowing requirements should converge as well. It is educative to see when this stress started showing: while the trend was clear from FY2012 onwards, it was the 30 percent-plus growth in SDL issuance for two consecutive years that the market seems to have been startled by.

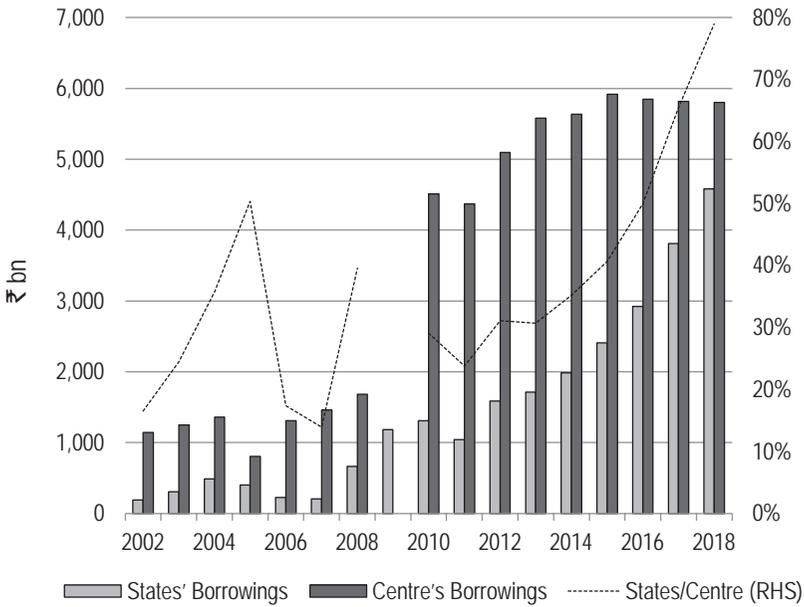
This is why the SDL yield spread over G-Secs (i.e., the yields on SDLs minus the yield on the 10-year Central Government bonds) started to

FIGURE 7. Revenue Deficit



Sources: RBI, Budget documents, Company data, Credit Suisse estimates.

FIGURE 8. State Borrowing versus Central Borrowing



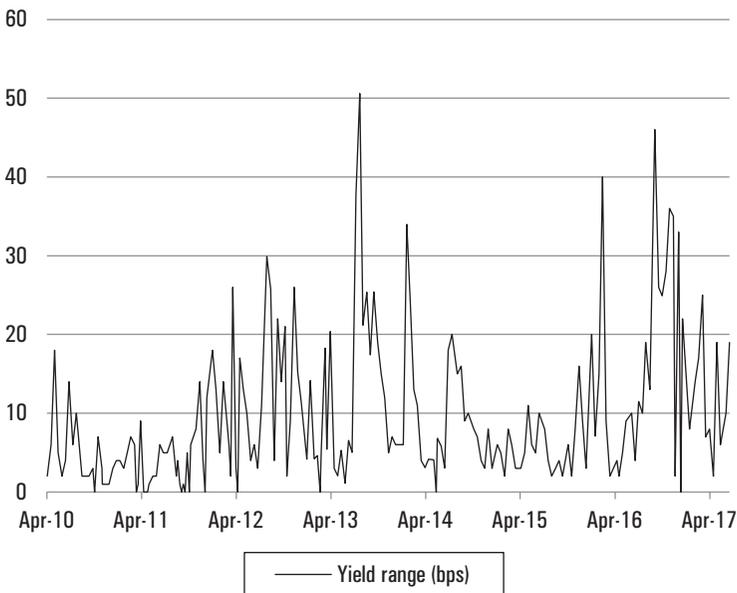
Sources: RBI, Budget documents, Credit Suisse estimates.

widen from 2015 onwards: the spikes in this spread are associated with the UDAY-related bonds, but the overall increase in their relative size of issuance undoubtedly has had a role too. The markets' tendency to extrapolate trends, and the absence of updated data (the RBI's compendium of state budgets comes with a lag of 14–15 months, by which time it is outdated for all practical purposes) has kept these fears high.

However, our aggregation of FY2018b state budgets suggests that this trend is already tapering off. Further, states are now funding most of their deficits directly through bonds, which is a healthier alternative from a transparency perspective (instead of through small savings schemes, where market mechanisms are bypassed), but has meant that bond issuance has grown faster than deficits. This ratio now appears to be peaking as well, implying that borrowing cannot grow faster than the growth in deficits. In Section 4.3, we discuss why the impact of farm loan waivers is unlikely to change bond issuance targets meaningfully this year.

Another trend that often gets highlighted is the bond market's lack of differentiation between states. The yields on Punjab's bonds are lower than the yields on Karnataka's, despite the debt to GSDP ratio for Karnataka

FIGURE 9. Yield Spread between States Remains Very Low, with Minimal Change over Time



Sources: RBI, Budget documents, Credit Suisse estimates.

being less than half that of Punjab. The yield spread for SDLs of different states issued in each auction (there are two a month) is rarely more than 20 bps, and this spread, while volatile, has not changed meaningfully in the period we are analyzing.

The spread between states is generally more dependent on the timing of the auction (e.g., yields at an auction at a time when there is a surfeit of issuance like during UDAY, could be much higher than at a time when issuance is weak) and the liquidity of the bond than the states' indebtedness. In Section 3.2, we discuss some reasons why this is the case, but for now this indicates that a debt-driven blow up is unlikely.

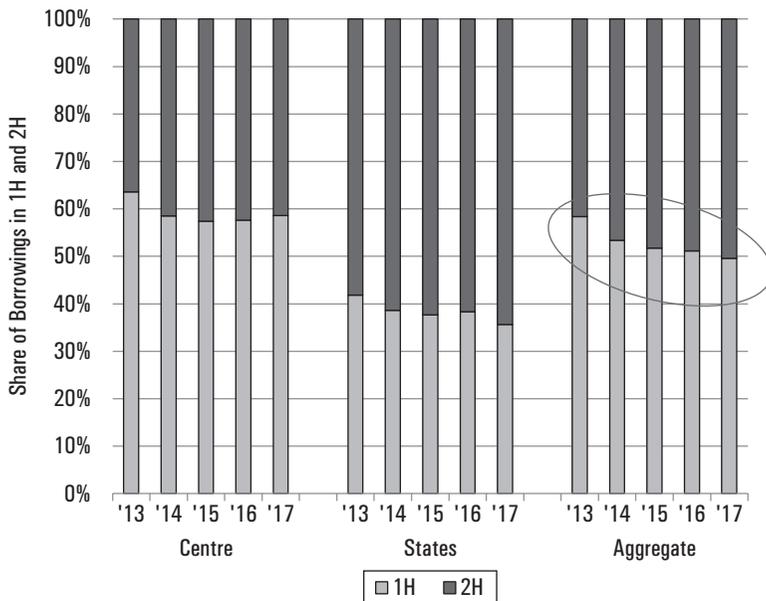
While clearly there does not seem to be any need for alarm, these changes do throw up some important questions, and also necessitate some changes. For example, the revised FRBM framework, as recommended by the FRBM Review Committee (the NK Singh Committee) sets a debt to GDP target for state governments as well. This has been set at 20 percent versus 40 percent for the Centre, and may require significant reduction in the states' fiscal deficits in the coming years. The ratio is currently 24 percent, and as many as 11 of the 18 major states (by the size of the budget) have the ratio above the target.

Where policymakers do need to change, however, is in the issuance calendar for states. State government borrowing is currently second-half skewed, and a disproportionately large quantum of bonds is issued in the final quarter. As demand for private credit in India is also skewed towards the second half of the financial year, which creates market distortions. To avoid unwarranted volatility, that is, too little demand on savings in the first half and too much in the second half, the Central Government generally schedules 60 percent of its borrowing in the first half, and 40 percent in the second half. As state issuances were much smaller earlier, their borrowing followed a more natural rhythm. However, as their share of general government bond issuance has climbed, they are now starting to distort the financial markets (Figure 10), and may even be the reason for some of the recent panic around state deficits. This needs urgent attention from policymakers.

3. Analyzing Expenditure Trends and Patterns

The share of states in combined government expenditure has increased from 51 percent in FY2011 to 65 percent in FY2018b. But do they spend wisely and more important, productively? How does one define productive expenditure:

FIGURE 10: First Half/Second Half Fiscal Year Imbalance in Total Government Borrowing Has Worsened with the Rising State Share



Sources: RBI, Budget documents, Credit Suisse estimates.

Note: 1H = First Half of the Fiscal Year; 2H = Second Half of the Fiscal Year.

is high capex always good? Further, while a greater share for states is in many ways true to the Constitution and should be irreversible and beyond debate, concerns have often been raised on whether the states have the capacity to handle such responsibility. Some apprehensions have also been expressed on whether social sector spending could be taking a back-seat as the Centre transfers control to the states. We analyze some of these issues in this section. While macroeconomic data is too coarse to provide conclusive answers to some of these questions, our analysis does uncover some revealing trends.

3.1. In Under-sized Governments Revenue Expenditure Still Appears Important

A common measure of the extent to which government outlay is 'wasteful' is the share of capital expenditure (capex): the implicit assumption here is that state governments have a natural incentive to spend on revenue items like salaries and subsidies, which can help them get votes, as against capex, which is typically of longer gestation, and could end up benefiting the government that follows.

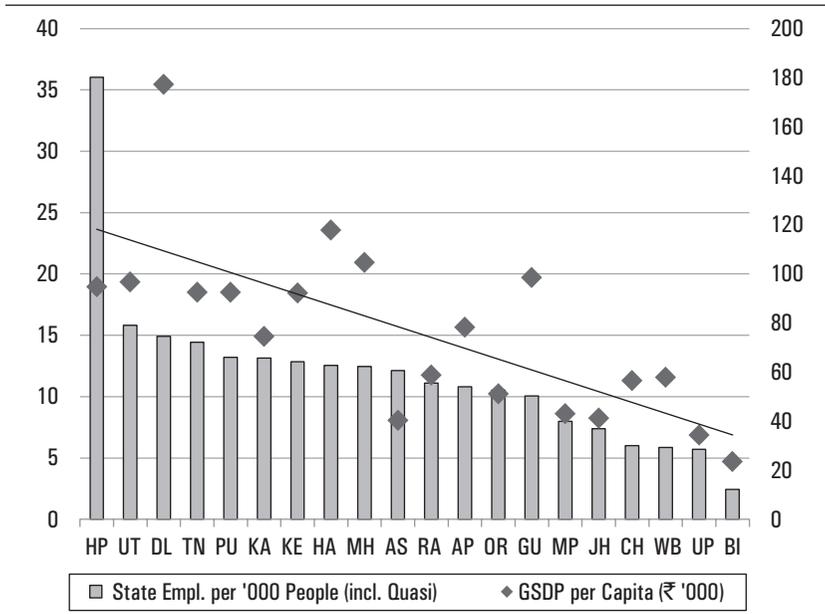
Capex is only about 17 percent of FY2018b state spending: this has fallen in the last two years from an all-time high of nearly 20 percent in FY2016, but is still among the highest seen in the last three decades. The ratio varies significantly among the major states: from less than 10 percent in Kerala to nearly 25 percent in Telangana. As many as 9 of the 16 major states have a capex ratio at or above 20 percent. Since FY2012, capital expenditure has increased at a faster pace than the overall expenditure, growing at 18 percent versus 16 percent overall.

In the last two years, state governments have been allowed to increase the fiscal deficit ratio up to 50 bps beyond the 3 percent ceiling if they meet specific conditions, that is 25 bps if they have a revenue surplus for the year, and their debt to GSDP is below 25 percent, and another 25 bps if the interest cost as a percentage of revenue receipts is less than 10 percent. These guidelines ensure that higher deficits are being incurred only for capex, and that the rise in debt, even if incurred for capex, should not trigger a debt sustainability problem. Some of the states like Madhya Pradesh and Telangana have used this leeway to increase their capex.

We would, however, caution against presumptuous conclusions that revenue expenditure is all bad. Most states that have below average capex ratios, like Kerala, Maharashtra, Haryana and Tamil Nadu, have above average per capita GSDP, and are generally considered more prosperous states. In fact, states with a larger government size, as measured in the number of government employees per unit population, appear to have higher productivity levels (Figure 11) (Mishra 2015). This is simply a correlation for now, and there are exceptions: for example, Gujarat has similar per capita GSDP as Tamil Nadu despite having 33 percent fewer employees, but it cannot just be a coincidence that all states with below average per capita GSDP also have small governments.

This surprises many economists, as it flies in the face of conventional thought that small government is good. In India, however, governments appear to be too small, not too large (though perhaps they are indeed bloated in some parts, making them much smaller than what appears in headline statistics in the departments where they need more working staff). A usual counter we hear is that Figure 11 just shows correlation, and the direction of causality could very well be on the other side, that is, more prosperous states have more funds to run the government and hire more staff.

However, we note that even on essential services like policing, the weaker states have a much smaller headcount per capita than the larger ones. Countries like Japan and Canada have 50 percent more police personnel (per unit population) than India with a ratio of 2.0 in 2013 versus just

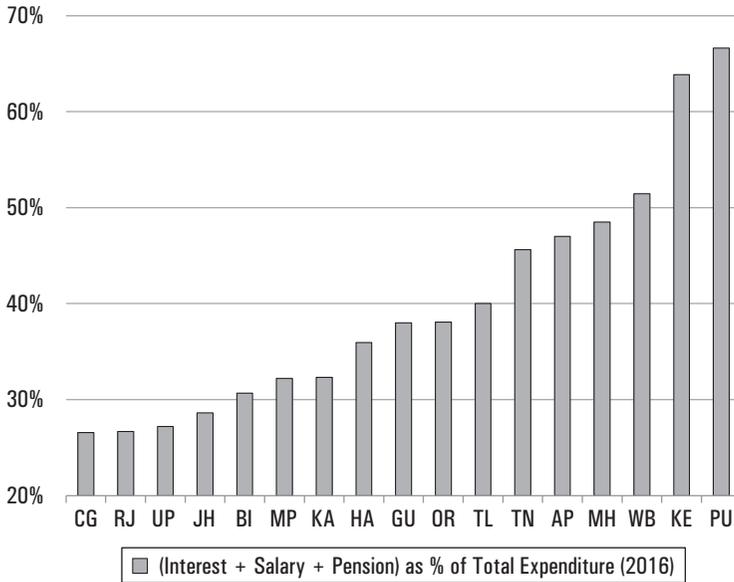
FIGURE 11. Low GDP/Capita States Have Fewer Employees

Sources: RBI, Budget documents, Credit Suisse estimates.

Note: State abbreviations on the x-axis are expanded in the Appendix.

1.38 in India, despite access to significantly better equipment like cars and smartphones that one can safely assume improve productivity as well. While the presence of central police forces like the Central Reserve Police Force (CRPF) and the Central Industrial Security Force (CISF), which continue to expand in size, and deal with the non-routine policing functions like combating Naxalites, does complement the police forces in most states, the aggregate numbers are still too low by global standards. Similar arguments can be made for state employment in education or even in State Transport Corporations. These are basic services that are sometimes best provided by state governments, and in their absence, the economy suffers.

Thus, the narrative that states like Tamil Nadu and Maharashtra have higher productivity because they employ more people and therefore provide better quality government services like maintaining law and order and also a social safety net, has much merit. That Bihar's police density was half of India's average, and even Uttar Pradesh was only at 1, partly explains the poor state of law and order, and the existence of musclemen and private militias in these states. This implies that revenue expenditure is not all bad, and a jump in hiring by state governments does not equate to wasteful

FIGURE 12. Non-discretionary Spend High for Some States

Sources: RBI, Budget documents, Credit Suisse estimates.

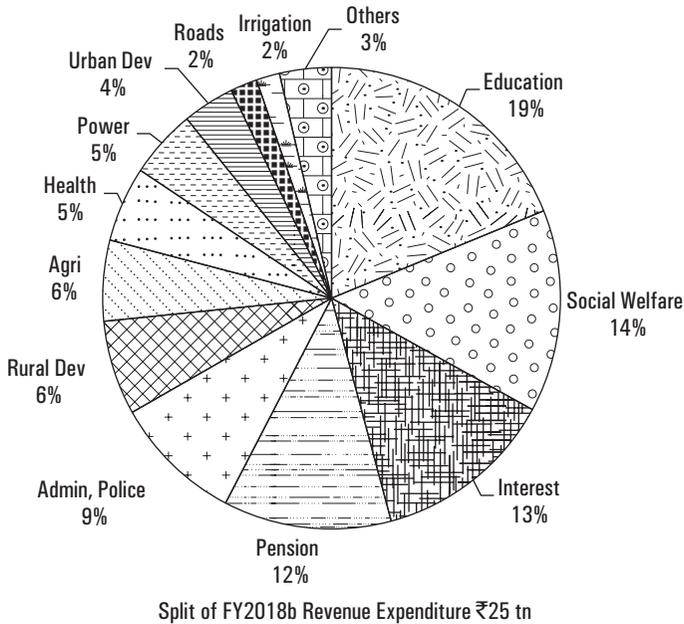
Note: State abbreviations on the x-axis are expanded in the Appendix.

spending. Most of state government employment is indeed for schools, law and order, urban administration and health.

It is within revenue expenditure that some worrying patterns emerge, particularly for some states. In Punjab, for example, the burden of salary, pensions and interest costs is as high as 65 percent of the total expenditure. As much as we in principle support better state government services requiring more personnel, these are non-discretionary expenditure heads, and they not only crowd out spending elsewhere, but also make the fiscal health quite fragile: even a minor revenue shock could create significant stress in these states. States like Kerala and West Bengal have such constraints too (Figure 12), but this does not appear to be a problem at the national level. Some developed states like Gujarat and Karnataka have this ratio well under control.

3.2. Focus on Social Spending Continues

A look at the split of revenue expenditure indicates that concerns that social spending gets de-prioritised may be misplaced. A third of the states' aggregate revenue expenditure is on education and social welfare (Figure 13); even Social Welfare in most states involves running schools and hostels for

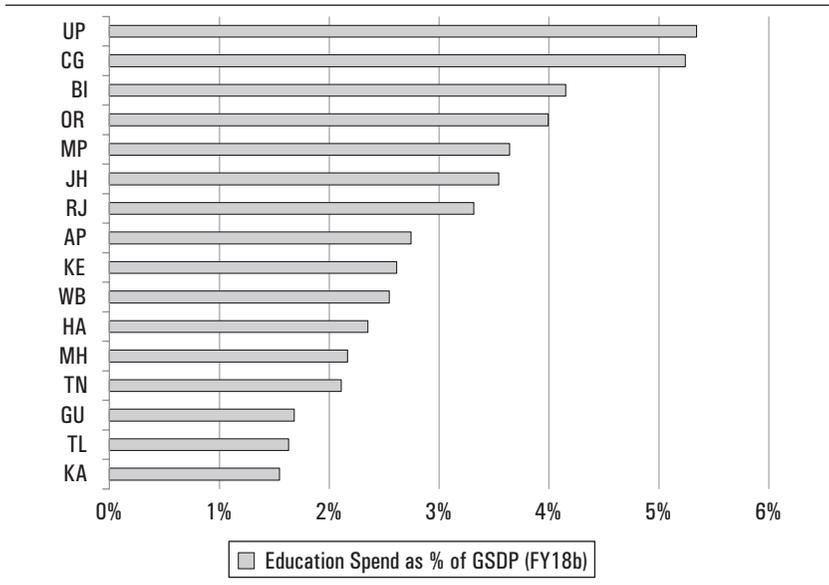
FIGURE 13. Split of States' Revenue Expenditure (FY2018b)

Sources: RBI, Budget documents, Credit Suisse estimates.

children of Scheduled Caste/Scheduled Tribe or Other Backward Castes, and various forms of subsidized education like scholarships. Further, the split of incremental expenditure between FY2015 and FY2018b suggests that this pattern has continued, with over 30 percent of the increase in spending on education and social welfare.

In particular, states' aggregate education spending as a percentage of GDP has been rising steadily, and is now at an all-time high of 2.9 percent, from being as low as 2 percent in FY2009, and 2.4 percent in FY2011. If there can be questions, they should be on the efficacy of this spending. Social welfare spending as a percentage of GDP has also been rising, and despite a slight budgeted decline in the ratio to 1.6 percent in FY2018b, put together, the states are to spend ₹2.7 tn on social welfare.

However, the trends vary between the states, and are in some cases deeply worrisome, particularly in education. Education spending as a percentage of GSDP varies widely from 1.6 percent in Karnataka to 5.2 percent in Uttar Pradesh (Figure 14), as does spending per student: from a low of ₹8,000 per year in Bihar to nearly ₹30,000 per year in Kerala. Thus, despite Bihar spending more than 4 percent of its GSDP on education, the spend per

FIGURE 14. Spend on Education as % of GSDP across States

Sources: RBI, Budget documents, Credit Suisse estimates.

Note: State abbreviations on the x-axis are expanded in the Appendix.

capita is nearly a fourth of that of Kerala where education spending as a share of GSDP is less than the national average of 2.9 percent. Needless to say, there are different spending models: Maharashtra for example, relies on aided schools—the state government expenditure is thus curtailed, without directly affecting the total spend.

Wide differences in terms of where states rank on these two ratios is explained by stark differences in per capita GSDP between them. Economically weaker states like Uttar Pradesh and Bihar appear to face a significant fiscal challenge in meeting their demographic burden: despite a high spend ratio they also have the lowest spending per student, and have a high Pupil Teacher Ratio. Particularly as these states also have the demographic pressure to educate children (as per the 2011 Census, a third of the population below the age of six is in Uttar Pradesh and Bihar), this is as much a fiscal problem as an administrative one.

3.3. Interest Costs: A Challenge Only for a Few States

Given the rise in state borrowing due to UDAY and the pick-up in deficit ratios since FY2011, there is an apprehension of a sharp increase in interest costs for states. However, we note that interest costs have been coming down

as a share of total spending for state governments since the peak of 19 percent in 2005, particularly after the restructuring of state debt in the middle of the last decade. At 10 percent it is now the lowest in three decades, though it varies from 4 percent to 16 percent of expenditure for various states. For comparison, 24 percent of central spending is on interest. Interest costs are a concern for the heavily indebted state of West Bengal (16 percent of total expenditure), and almost irrelevant at 4–8 percent of total expenses for states like Chhattisgarh, Odisha, Jharkhand, Bihar and Madhya Pradesh. Further, 75 percent of all interest costs are now paid on loans directly issued by state governments. This is in stark contrast to the situation before 2000, when most of state debt consisted of loans from the Centre.

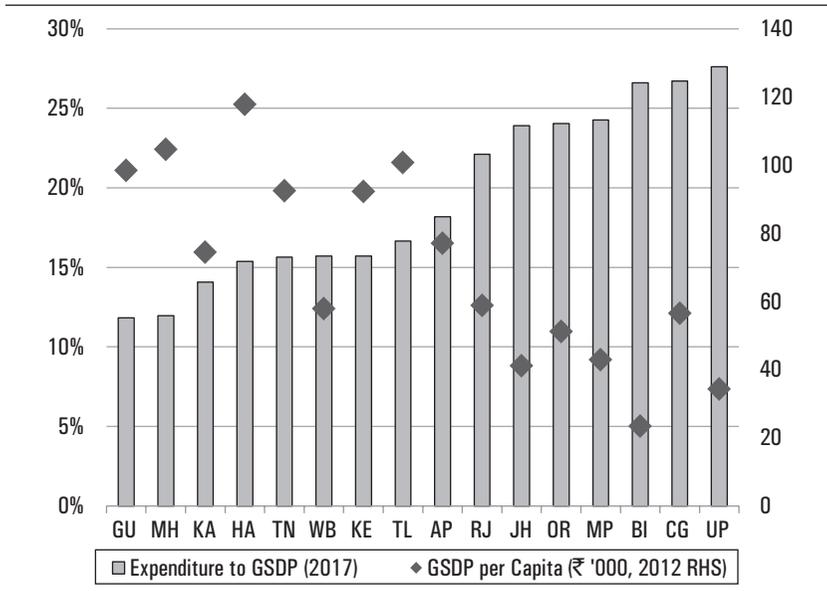
While interest costs are a lagging indicator (when they start climbing as a share of expenditure, the borrower is already well into the debt trap), they do not appear to be an immediate area of concern. As a result of UDAY, aggregate state debt to GDP has nudged up in the last two years, but at 24 percent it is still meaningfully lower than the extreme levels seen in the period 2000–2007 and only marginally off the bottom.

However, there is a significant skew in the debt distribution, as most of the states are meaningfully above the 20 percent of GSDP recommended by the FRBM Review Committee. The lower debt to GSDP in some heavyweight states like Maharashtra, Karnataka and Tamil Nadu brings down the overall ratio. For the economically weaker states, reducing the ratios in the next five years could be cumbersome (we look at this in detail in Section 3.4).

The share of interest costs in total expenditure does not seem to be correlated to the indebtedness of the state: Uttar Pradesh and Bihar, for example, have high debt levels but interest costs are a smaller part of expenditure. This is due to these states having very high expenditure to GSDP: in fact, the weaker states appear to have higher expenditure to GSDP (Figure 15). As discussed earlier, most of these states are more reliant on Central transfers to fund their budgets than the states that are better off. Further, as a share of the state's economy, governments are much larger in the weaker states.

For most states, there is limited risk of a debt trap for now, that is, where rising debt drives interest rates higher, and the resultant jump in interest costs squeezes spending, which slows the state down, and hurts revenues. With nominal GSDP growth mostly in double digits, a fiscal deficit ratio below 3–3.5 percent can make a debt spiral unlikely, in our view.

Some of these complexities contribute to why market forces do not seem to discipline the States, and debt to GSDP seems uncorrelated to their borrowing costs. Much ink has been shed on analyzing this “failure of the markets”, particularly as there is no explicit sovereign guarantee. We find

FIGURE 15. Economically Weaker States Have a Higher Spending Ratio

Sources: RBI, CSO, Credit Suisse estimates.

Note: State abbreviations on the x-axis are expanded in the Appendix.

three reasons why this is so. Firstly, the Central Government controlling state borrowings (see the discussion on Article 293 in Section 2.3) is natural protection from the state going under. Secondly, the RBI acts as the banker to state governments and conducts the bond auctions, and provides bond buyers with a claim on tax revenues. Thirdly, the buyers of these bonds are mostly insurance firms and banks for whom these bonds are part of statutory holdings—with most of them being government-owned in any case, there is no intention of differentiating between States.

A bit of history can provide some additional perspective on why bond holders assume the implicit guarantees. Till the middle of the 1990s, when most of the banking system was still nationalized, state government bonds were allocated by the Central Government to different banks. They are thus conditioned to holding these as guaranteed by the Centre, and did not really care which state's bonds they were getting. Even after state bonds started getting auctioned, this link has continued.

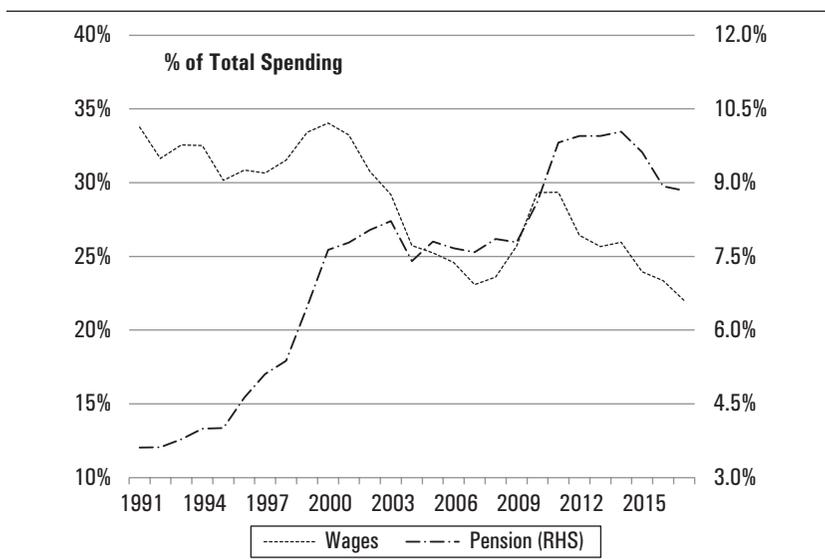
Further, even in more loosely integrated entities like the European Union (EU), yield spreads among EU members narrow when the Union's survival is not in question. They widen when the market fears fissiparous tendencies are on the rise. India is much more tightly integrated, and is a union of states, as against being a federation.

That means the Central Government remains the only entity that can potentially discipline recalcitrant states in the case of persistent profligacy. That said, the Centre itself, sometimes for political reasons, like in the case of West Bengal a decade and a half back, can permit profligacy (the communist parties in power in the State were supporting a minority government at the Centre). The Centre had taken advantage of the debt restructuring of 2005, and the fiscal incentives given by the 12th Finance Commission to get states to legislate their own FRBM targets. Such an opportunity may be utilized to encourage them to adhere to the debt to GDP targets set by the FRBM Review Committee.

3.4. Salaries Mostly in Control, but Pension Expenses Spiralling Up

State governments' salary and pension bills deserve attention as they provide most of the government services and employ nearly four times as many people as the Centre. Their ₹6 tn wage bill in FY2017 was 2.2 times the Centre's and pension expenses at ₹2.4 tn were 1.4 times the Centre's bill. The share of salaries in total expenditure has fallen over the past three decades from nearly 35 percent to 22 percent: the decline has been quite steady, with the exception of the years in which pay commissions are implemented. On the other hand, the share of pensions has been climbing, having moved from just above 3 percent of expenses to nearly 10 percent now (Figure 16).

FIGURE 16. Falling Share of Salaries and Rising Share of Pensions in Total Expenses



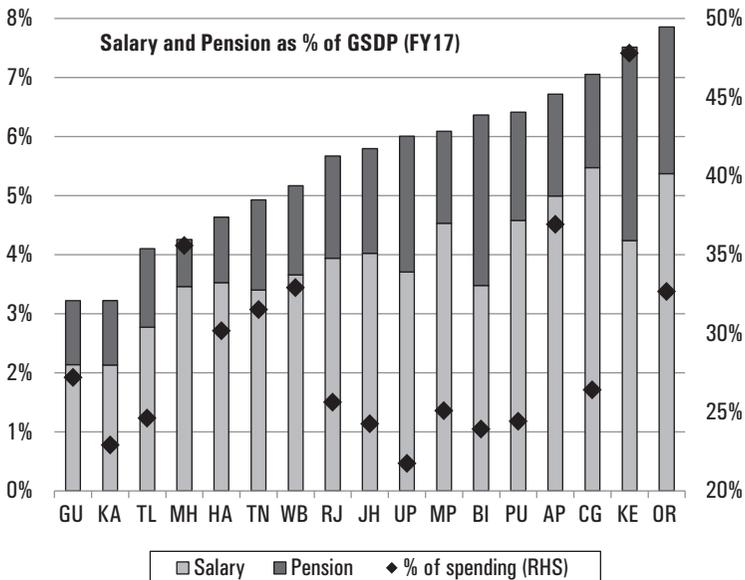
Sources: RBI, Budget documents, Credit Suisse estimates.

This is worrying, particularly as pensioners for state governments are now growing. While most states moved from defined benefit pension schemes (which can have potentially unlimited liability) to defined contribution schemes about a decade back, the impact of this change will only become meaningful in a few decades, and for now implementation of every pay commission increases the pension bill sharply.

Salary and pension expenses vary significantly among the states, both as a percentage of total spending (i.e., the fiscal impact) as well as a percentage of GSDP (a measure of government productivity in a way). Thus, Kerala stands out in having nearly half its expenses paid out for salaries and pensions, with more than a fifth of all expenditure being pensions. One reason could be that it was the last to transition to a defined contribution scheme, but it is too soon for that difference to show through. In general, the high ratio to GSDP for some of the economically weaker states like Odisha, Chhattisgarh, Bihar, Madhya Pradesh and Uttar Pradesh is likely due to a mix of inefficiency as well as these States being at early levels of development, where tax generation and growth of private enterprises are still nascent (Figure 17).

The Centre implemented the 7th Pay Commission recommendations in phases: basic salaries were changed starting April 1, 2016, and the

FIGURE 17. Salary and Pension Expenses as % of Total, and as % of GSDP



Sources: RBI, Budget documents, Credit Suisse estimates.
 Note: State abbreviations on the x-axis are expanded in the Appendix.

allowances were hiked from July 1, 2017. State governments can set up their own pay commissions, but in the past most have just adapted the Central recommendations. In the current cycle, states like Andhra Pradesh and Telangana were the early birds: they raised salaries at the time of the creation of Telangana. Gujarat and Madhya Pradesh also implemented their revisions shortly after the Centre. Some states like Tamil Nadu have announced plans to implement from FY2019, Karnataka has set up a commission which suggests it would implement after the State elections in 2018, while many others have not made any announcements. Growth in salary expenses (we take a five-year average to even out one-off factors) shows wide disparity among states: some of this is due to the different timelines of implementation, as the 6th Pay Commission implementation was spread over many years, lasting till 2013 in some states.

States adding up to about 18 percent of the salary bill had implemented the 7th Pay Commission by May 2017, implying that a further increase of ₹1.7 tn is possible over the coming years. While the states salary spends will rise sharply as they are in the process of implementing the pay hikes, we add a word of caution. In an experiment (Muralidharan 2016), it was found that despite an improvement in teachers' pay and satisfaction, there was no effect towards upgrading their own skills and no effect on the ultimate outcome of student learning. Their conclusion was that unconditional pay increases constrain fiscal space without a corresponding increase in productivity, and can be construed to be helpful.

3.5. The Rigor of the Budgeting Process Needs Improvement

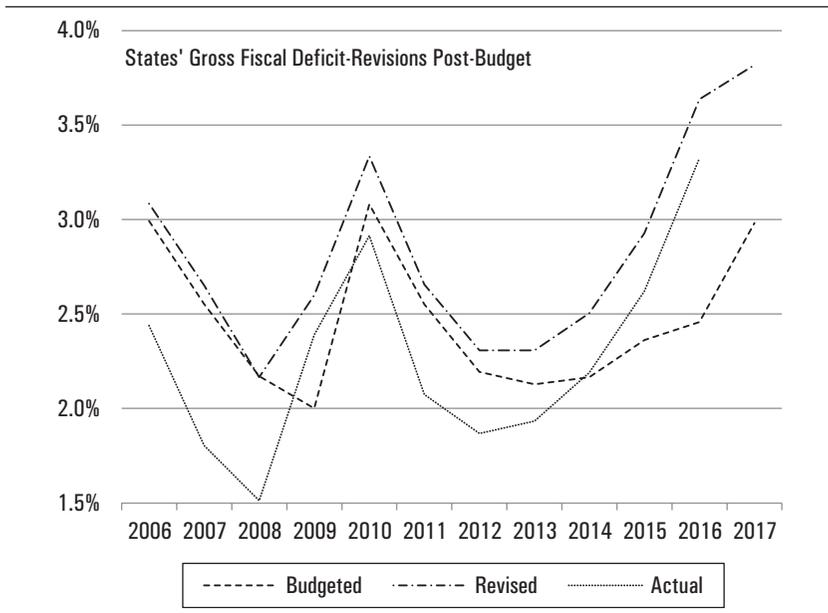
As we saw in Section 1, state governments now manage nearly two-thirds of total government expenditure in India. In the absence of a Planning Commission there is apprehension that the spending by state governments could be uncoordinated, inappropriate or wasteful. Given the size of their spending, poor planning can also cause significant volatility.

For example, we find that for three consecutive years, that is, FY2013, FY2014 and FY2015, final state expenditures were more than 1 percentage point of GDP lower than budgeted, and were as much as 1.8 percentage points of GDP lower than budgeted in FY2014. There are several drivers of differences between BE, RE, and the final receipt, expenditure and deficit numbers: volatility and unpredictability in Central transfers, incorrect estimation of own taxes, last-minute efforts to meet fiscal deficit targets (as states also do cash-based accounting like the Centre, delaying expenditures to the next fiscal year helps meet deficit targets), as well as poor execution on various schemes and projects.

Surprisingly, in each of the years between FY2010 and FY2016 (the last year for which final expenditure data is available), the RE expenditure was higher than BE, and at the same time, the final expenditure was lower than not only RE, but also BE. Why would states raise their expenditure targets with just two to three months to go, only to eventually miss even the earlier, lower targets? This usually occurs because the departments that are unable to spend their allocated quota are loathe to “surrender” the amounts till the last month, and the departments that are ahead of their spending targets demand and get an increase in allocations. Given the large sums involved, usually squeezed into a few months, this can and does drive volatility in economic momentum, particularly when states implement spending cuts at the very end of the year.

Interestingly, the final fiscal deficit in most years comes at or below the budgeted deficit target (Figure 18): the slippage against that in the last two years has been mainly due to UDAY. This is perhaps another reason why the UDAY-related spurt in deficits spooked the markets: it was only in these two years that eventual state deficits were higher than BE. In fact, deficits in RE too are higher than what finally transpires, and therefore, market participants in the interim work with higher estimates

FIGURE 18. Final Deficit Is Always Lower than RE



Sources: RBI, State Budget documents, Credit Suisse estimates.

of state deficits and borrowing than is needed. The 14–15 month delay with which state budget aggregates are made available by the RBI makes the market perception worse.

3.5.1. UNCERTAINTY AROUND CENTRAL TRANSFERS

An important source of volatility for state finances is the uncertainty around Central transfers: in some years these have been as much as one percentage point of GDP lower than budgeted. The bulk of the shortfall (70–90 percent between FY2010 and FY2016) has been in grants, hurting the implementation of specific schemes. Many of these grants are conditional, with stringent conditions that states occasionally struggle to comply with, and are also often “matching grants”, implying that the states would need to contribute as well so as to get the Centre’s transfer.

Worryingly, assumptions for receipt from the Centre are not modified while preparing the RE—it is only in the final reading that the slippages became visible. One of the reasons for this is a timing problem: while its tax collections vary from month to month, the Centre transfers a steady quantum to the states every month. In the twelfth and final month, that is March, an adjusting amount is also transferred based on the actual collections (so there are thirteen transfers in total). The fixed amount transferred every month is decided at the beginning of the year, which means it is based on the Centre’s budget estimates. So, any difference in its own tax collection versus the budgetary targets affects only the final transfer in March: the states cannot know this in advance. That nearly 15 percent of all tax collections for the Centre also occur in March makes this a substantial amount.

3.5.2. SLIPPAGES IN OWN TAX RECEIPTS HAVE PICKED UP IN RECENT YEARS

Over the past decade, the gap between state governments’ budgeted estimates of own tax revenues and the final collection has ranged from -0.6 percent to +0.3 percent of GDP (the negative sign indicates slippage, and positive indicates excess). Taxes were higher than budgeted from FY2010 to FY2013, but in the last four years budgeted estimates of own tax revenues have turned out to be too optimistic. The gap between budgeted and final numbers was widening sharply till FY2016, after which it appears that states reset downwards their expectations of tax buoyancy, and budgeted estimates for own taxes as a percentage of GDP fell. Budgeted estimates of own tax receipts in FY2018, at 6.4 percent of GDP, are nearly 0.4 percent lower than the 6.8 percent budgeted in FY2016, though still 0.2 percent higher than the 6.2 percent that was collected that year.

Surprisingly, in every year since FY2014, final numbers have been meaningfully lower than RE, even as the RE was lower than BE. Large differences when the estimates were made with just 2–3 months left to go indicate either sloppiness in budgeting or apathy. As final own tax receipts were almost exactly equal to the estimates in RE from FY2010 to FY2013, when they were also generally higher than BE, this indicates an unwillingness to rectify over-optimistic assumptions.

Looking at state-wise numbers, the problem seems widespread. In both FY2015 and FY2016, for example, all the major states other than Maharashtra and Karnataka saw slippages (actual versus BE) of nearly 10 percent or above, with states like Jharkhand, Bihar, Uttar Pradesh, Tamil Nadu, Kerala and Chhattisgarh seeing slippages of 15–20 percent. Only Odisha saw a positive surprise. While forecasting is never easy, and rarely accurate, this level of inaccuracy points to a lack of rigor in the budgeting process that is worryingly widespread among states.

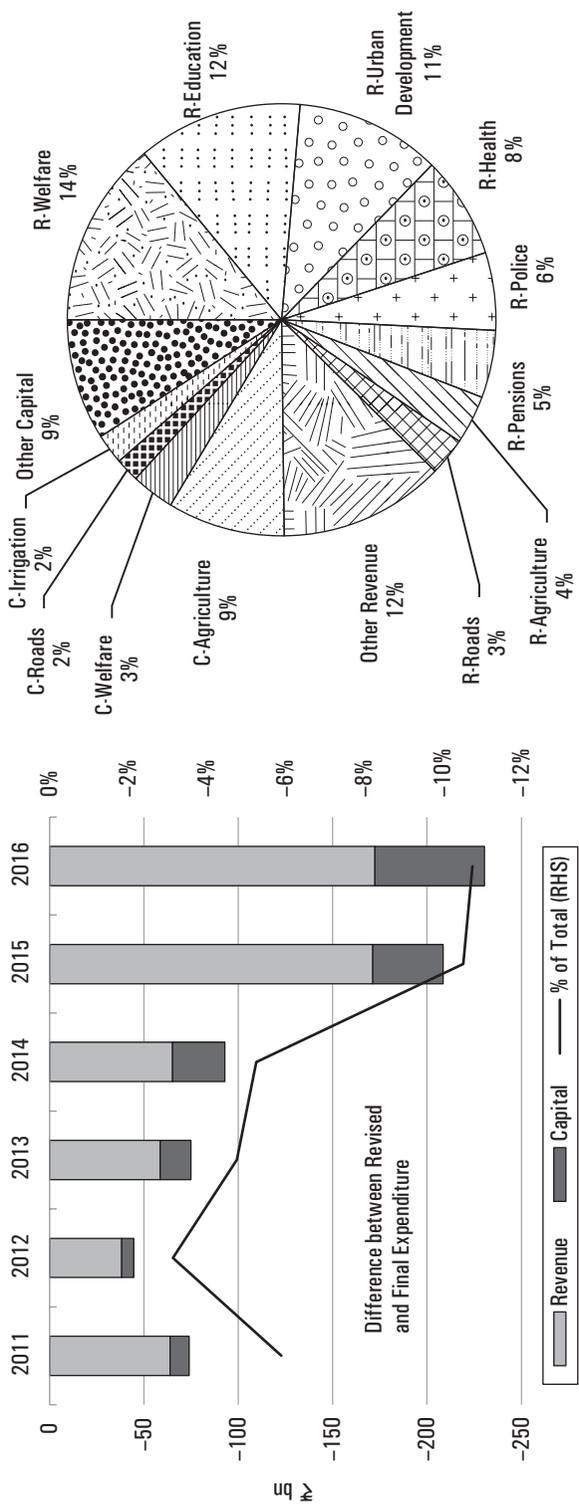
3.5.3. EVEN REVENUE EXPENDITURE GETS PUSHED OUT

Combined with the volatility and unpredictability of Central transfers, slippages on own tax projections drive down expenditure, given that the budget deficit targets are impregnable: lower receipts equal lower expenditure if the difference between them is fixed (see the discussion on Article 293 in Section 2.3). States generally tend to spend less than budgeted: in the years FY2015 and FY2016, almost all the major states spent 5–20 percent less than budgeted. The exceptions were Rajasthan, Haryana and Jharkhand in FY2016, where mid-year policy changes like UDAY drove a sharp increase in headline expenditure. The expenditure shortfall is partly due to shortage of funds, but also due to the inefficient execution of programs: projects seeing delays due to execution challenges are unlikely to use all the allocated funds in time.

To get a better understanding of the nature of the expenditure cuts, we drill down into the Maharashtra budget: the state accounts for a sixth of India's GDP, and is the second most populous as well as having the second largest expenditure budget among states. The gap between budgeted and final expenditure for Maharashtra is low compared to many other states, but the slippage has been picking up over the years (Figure 19). This is explained by the trend of growing unpredictability of Central transfers as well own tax receipts.

There is a widely held view that delayed expenditure due to insufficient funds is generally capital expenditure. However, data shows that most of the curtailment of expenditure appears to be on the revenue front, and is

FIGURE 19. Split of Unspent Funds in Maharashtra, FY2017RE



Sources: State budget documents, Credit Suisse estimates.

widely spread across departments. In revenue expenditure heads like welfare, this can mean schemes running out of funds in the last few months of the year, but surprisingly, even expenditure on education is lower than budgeted. Newspaper reports talking of teachers' salaries getting delayed in some years point to the state taking extreme measures to manage its cash flows. In states like Bihar, where RE deficits can be as high as 5–8 percent of GSDP but the final deficit ratio is less than 3 percent, even salaries for government employees can be unpaid for months.

As governments do cash accounting instead of accrual accounting, this push-out of expenditure to later years is a common stratagem. For the economy, as state government expenditures are now nearly 20 percent of GDP, this fudging distorts seasonality of economic activity, as governments stopping bill (or even salary) payments in the month of March, can slow down activity levels. Between FY2015 and FY2017, as the gap between BE and actual expenditures expanded, activity in the January to March quarter turned out to be slower than seasonal, and that in the April to June quarter was stronger, as payments pushed out from March were made in April and May. This volatility disturbs economic sentiment by reducing predictability, which is essential for businesses to have the confidence to invest. That the Central Government also often relies on such techniques makes the economic impact worse.

A more robust and accurate budgeting process is thus the need of the hour.

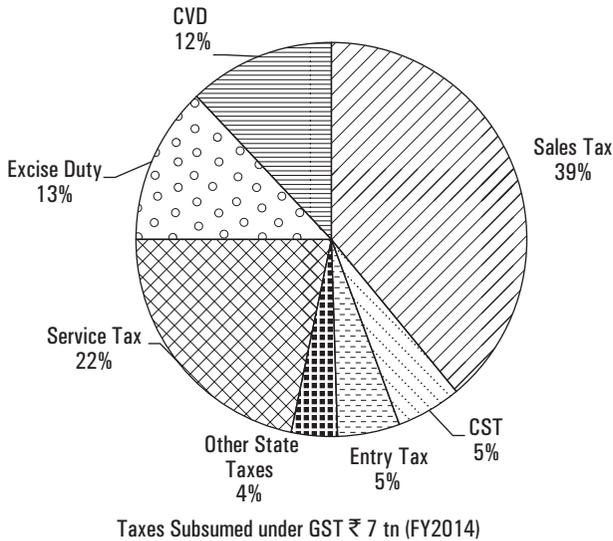
4. Assessing the Impact of GST, Loan Waivers and FRBM Review

Three developments are likely to have a significant impact on the state governments' budgets in the coming years: the Goods and Services Tax (GST), farm loan waivers, and the recommendations of the FRBM Review Committee. We analyze the implications in this section.

4.1. GST Impact on States Unclear, Compensation Agreement May be Too Generous

The start of GST on July 1, 2017 is an epochal event. There are many meaningful ways in which it can impact state budgets, but we focus only on first order effects.

Of India's tax collection (based on FY2014 numbers), 40 percent merged under GST. While the split between the Centre and the states for FY2014 (Figure 20) suggests a 57:43 split in favor of the states (we use FY2014, as the Revenue Neutral Rate Committee, which did the most detailed work on

FIGURE 20. GST Subsumes 40% of India's Tax Collection: Its Split (FY2014)

Sources: Revenue Neutral Rate Committee Report, Credit Suisse estimates.

GST revenues in our knowledge, had used this as the base (Subramanian 2015), the GST Council has set SGST and CGST to be equal. At the same time, the Council has sequestered about 8 percent of the taxes into a GST compensation pool: these are the cesses imposed over and above the standard GST rates. If state receipts of GST fall below the 14 percent annual revenue growth (on FY2016 as the base) promised to them, this pool would be used for compensation. Assuming this is part of state revenues, the split becomes 54:46 in favor of the states. In addition, service tax (a Central revenue source pre-GST) has grown much faster in recent years, as the base was widened, and then rates hiked repeatedly: this would have raised the Centre's share of taxes subsumed by GST.

Prima facie it appears that the compensation agreement for the states is too generous. The 14 percent CAGR growth assumption for the next five years assumes that without GST the states would have seen revenues grow 2 percentage points faster than 12 percent annual nominal GDP growth. However, in the last four years, the states' own taxes have barely beaten nominal GDP growth: growth in FY2017r was slightly better, but it is likely to get revised down when actual numbers are published. Further, with inflation now moderating to very low levels, nominal GDP growth is also clocking below 12 percent: it therefore appears that the Centre may

have been too generous in setting the compensation threshold. If GST delivers significantly more revenues than the taxes it subsumed, either due to the rates being set at a higher level, or because of improved compliance, the compensation requirements may be lower. But that assumption would be presumptuous at this early a stage.

The much harder to assess impact is on how taxes get distributed across the states. If one assumes revenue neutrality at the Centre, the Central transfers should stay unchanged, or at least affect the states equally. The challenge is in calculating how the taxes get distributed between states, given that GST is a tax on consumption, as against several pre-GST levies like excise that were taxes on production. The debate on which states benefit and which lose has been focused only on CST so far, which is just 5 percent of taxes subsumed under GST (Figure 20), even though some states, like Gujarat, Maharashtra, Tamil Nadu and Uttar Pradesh, dominate its collection. These “producer states” worry about losing revenues (CST is like an export tax on inter-state goods movement).

However, there are many other moving parts and our modeling exercise suggests that at least some of them need not worry. Put simply, in the GST regime a state loses part of sales tax on goods consumption within the state but gains part of service tax levied in the state. Let’s take Maharashtra (MH) as an example. It currently gets 2.4 percent of service tax (as part of the tax sharing of Central revenues) but under GST may get 9.7 percent (MH is 17 percent of India services GDP, so it would get half of that, in addition to 2.4 percent of the other half, adding up to 9.7 percent). It would lose part of sales tax it currently collects (14 percent of the national total), but that would be offset by a higher share of excise duty and counter vailing duty as it consumes more too. Thus, given its relatively greater prosperity and therefore higher share of consumption than other states, it may be better off in the GST regime.

Given the paucity of data, it is difficult to assess the overall impact accurately, but as a principle it can be said that a state that has a higher share of taxable services GDP than its current share of sales taxes would benefit, and a state with the converse would lose revenues.

States do not seem to be prepared for these changes, and there could be significant disruption in FY2018, and likely in FY2019 too, as the state budgeting machinery grapples with these changes, but the promised compensation should eventually address any gaps that emerge. From FY2019, most states may just project a 14 percent growth rate in revenues, as that becomes the floor revenue.

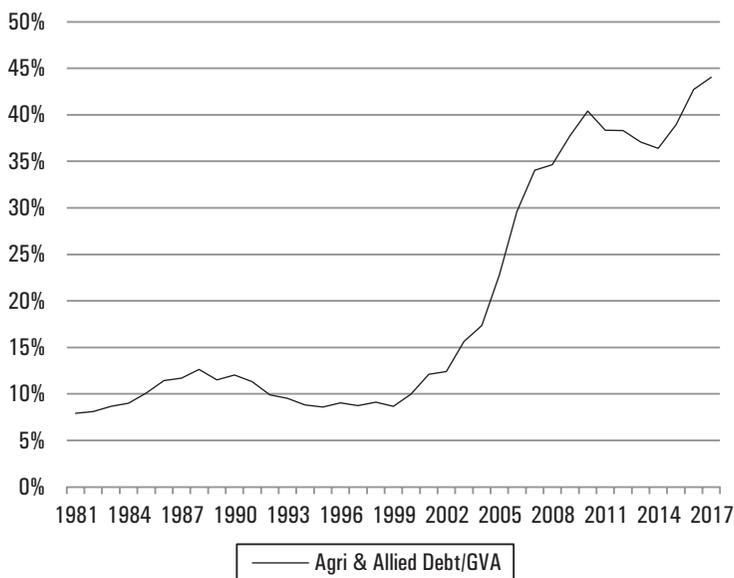
4.2. Loan Waivers: A Risk for Expenditure Quality, but Not for Fiscal Deficits

The clamour for crop loan waivers has been spreading: Madhya Pradesh, Haryana and Rajasthan may join Uttar Pradesh, Maharashtra, Punjab and Karnataka in being forced to announce waivers. While there may be a political aspect to farmers' protests too, in our view, rising agricultural debt when agricultural income growth is slowing is the driving force (Figure 21).

Between FY2005 and FY2014, the annual growth in Gross Value of Output (GVO) of agriculture was 14 percent, mostly driven by higher price growth. This had slowed to sub-5 percent growth in FY2015 and FY2016, the years of two successive monsoon failures. It was expected that normal rainfall in 2016 would drive a sharp rebound in agricultural income growth. After all, in FY2010, the year after the previous monsoon failure, growth in agricultural GVO was 21 percent.

However, as feared by some (Mishra 2016), a good monsoon did not revive farm income growth in FY2017, and growth of agriculture GVO remained in single digits. While volumes indeed rebound as expected, pricing was weak, as rising supply met stagnant or slow-growing demand. The signs were clear even during the drought years, as volumes had not declined

FIGURE 21. Agriculture and Allied Debt Now 45% of Agriculture GVA



Sources: RBI, CSO, Credit Suisse estimates.

meaningfully, except in the case of the primarily rain-irrigated crops like pulses and oilseeds. More importantly, contrary to the trends seen in prior droughts, food prices did not spike—instead, food price growth slowed from the elevated years seen in the previous years.

Improving infrastructure in rural areas has lifted agricultural productivity in India (that it lags behind global norms has long been an area of concern for policymakers). At the same time, with population growth slowing down to 1 percent a year, and increasing automation bringing down calorie needs (Deaton and Dreze 2009), aggregate demand for calories is not growing as rapidly. It is therefore difficult to expect food prices to rise—this is a reversal of a multi-decade trend in the Indian economy. Since 1962, while agricultural output (in real terms) has grown at 2.5 percent a year, price growth has been 7.5 percent a year. The slowing down in price growth has stymied an important process of income transfer from the rich food consumers to the poorer food producers.

Meanwhile, agricultural loans from Scheduled Commercial Banks (SCBs) have compounded at 15.5 percent CAGR over the past decade. The growth rate in agricultural credit has now slowed down to close to the nominal GDP growth, but only after credit outstanding quadrupled between 2004 and 2009. But agricultural incomes are growing even less rapidly. Therefore, at ₹12 tn, agricultural credit is now at an all-time high as a percentage of agricultural GVA (Figure 21). While a debt to income ratio of 45 percent is far from unsustainable, loans as well as incomes are not uniformly distributed, and the sharp rise in the ratio suggests that the viability of many of these loans may now be questionable.

After Andhra Pradesh and Telangana announced waivers in 2014, recently four more states (Uttar Pradesh, Maharashtra, Punjab and Karnataka) have announced them: they together account for 35 percent of the ₹10 tn of outstanding agricultural loans at the end of March 2016, according to RBI data. In addition waivers are already part of the discourse in Madhya Pradesh, Tamil Nadu (where cooperative loans have already been waived and SCB loans could be taken up too), Gujarat, Haryana and Rajasthan: these together accounted for 32 percent of SCB loans in FY2016. In FY2017, and including loans of Regional Rural Banks and Co-operative Banks, which were about one-third of the loans outstanding from SCBs, the nine states (excluding Andhra Pradesh and Telangana) would add up to ₹9.6 tn. However, the total amount waived is likely to be a fraction of that.

The mechanism of farmer identification would vary across states, but it appears that states are screening for accounts with outstanding amounts of less than ₹100,000 or ₹150,000. Accounts with less than outstanding

amounts of ₹200,000 (a separate categorization for ₹100,000 is not available) were 41 percent of the loans and 86 percent of the accounts in FY2016. This explains why Maharashtra and Uttar Pradesh chose to waive about 30–31 percent of the outstanding agricultural loans. If all states where these issues are being discussed were to waive loans in this proportion, the quantum would be ₹2.1 tn. However, in states like Punjab and Karnataka, smaller amounts, that is, 16 percent and 9 percent, respectively, of the loans are being waived (for now). This suggests that the aggregate waiver could be about ₹1.5 tn: the total for the four states that have already announced is ₹840 bn.

Even in states where farm loan-waiver announcements have been made, execution of the waivers, that is, payments to banks by the government, could take several years. The 2008 Central loan waiver took 2.5 years from announcement to completion, and was 30 percent smaller than what was announced. The scheme was announced in the Budget in February and cleared by the Union Cabinet in May 2008. However, the first disbursement, for about 40 percent of the announced amount, happened only in December 2008. Additional sums were paid in May and August 2009 and January 2011, and some minor payments continued till 2012.

The reason for this prolonged execution is not just lack of fiscal space, but also the complexity of identifying individual beneficiaries, and finalizing the waived sum. While the basic contours of these waivers, which matter politically, have been publicized, they need to be translated into individual details. State governments need to identify who benefits and who does not, and this means answering several non-trivial questions: Should there be crop-specific waivers, should those with irrigated farms get less, should absentee landlords get nothing, and by corollary, should tenant farmers get more? What should be the quantum of waiver, and how should this be phased? We understand that data on loans is not linked to specific crops, tenancy records are patchy, and irrigation data is not updated. It is likely to take state governments many months to identify beneficiaries and execute the plan: for example, in its due diligence, part of which was to link these loan accounts to Aadhaar, Maharashtra has recently discovered that nearly 15 percent of the loan accounts were fraudulent.

In view of the control the Central Government has over state government borrowing, and thus their fiscal deficits, the Centre's decision to ask states to find their own sources of funding could drive them to spread these waivers out over several years, like Andhra Pradesh and Telangana were forced to do. If so, the estimated amount of ₹1.5 tn is likely to be spread out over 4–5 years, particularly as many of the states have not announced waivers yet. Thus, the annual impact could be in the range of ₹300–350 bn: not small change, but only 0.15–0.20 percent of GDP.

Even this amount would show up as reallocation of spending, making this a problem of expenditure quality instead of an increase in state fiscal deficits. This brings up the question of the impact of these waivers on the supposed beneficiaries:

- The obvious moral hazard of any loan waiver would show up in borrower behavior over many years. That said, in the near-term, microfinance firms operating in rural areas have not seen any meaningful increase in defaults—this may be due to a different set of customers, and the perceived difference between bank loans and loans from microfinance firms.
- During the period in which the loan waiver is being executed, banks slow down lending in those areas: this was clearly visible in Andhra Pradesh and Telangana, where loan growth dipped sharply. In Andhra Pradesh, growth in outstanding loans slipped from well over 30 percent a year to low single-digits. In Telangana as well, growth slowed from 25 percent a year to 5 percent. While some of this would be due to the waivers reducing the loan amount, and disbursement data is not available, there is an obvious procedural challenge (not to say risk) in lending to individuals whose loans are being waived.

Nationally, growths in April 2017 and May 2017 have already slowed down to 1 percent and 7 percent, respectively, the lowest levels in a decade. This slowdown was not visible in 2008–09, most likely because a bank's priority sector lending targets are set on the previous year's closing total loan balance. As FY2008 was a strong growth year for bank loans, the targets for FY09 were set at a high level. Further, the waiver of loans made a number of new farmers eligible for new loans, and that supported loan growth. In FY2017 on the other hand, system loan growth was only 5 percent, and for most public sector banks, growth was zero or negative. Thus, there would also be minimal regulatory pressure on banks to continue agricultural lending.

Loan waivers can, therefore, counter-intuitively hurt the inflow of new cash into the agricultural economy. The cash from loans that are being waived has been consumed already.

4.3. FRBM Targets for State Governments Require Minor Fiscal Consolidation

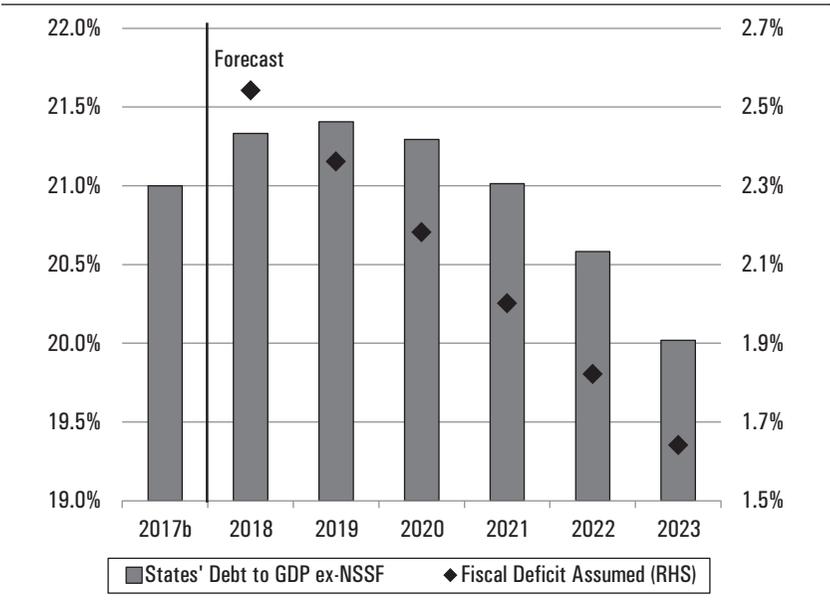
The FRBM Review Committee has recommended that a general government debt anchor of 60 percent be achieved by FY2023, with a ceiling of 40 percent for the Centre and 20 percent for the states. As of FY2017- end,

general government debt to GDP stood at 67 percent, with Centre at 49 percent and the states at 24 percent (the liabilities of Centre and the states do not add up to the combined liabilities on account of inter-governmental transactions). Excluding the National Small Savings Fund (NSSF) liabilities, the ratio for states falls to 21 percent.

The Committee presents various scenarios for the States’ debt to GDP trajectory beginning at 21 percent (ex-NSSF liabilities) in FY2017. For this ratio to fall below the 20 percent ceiling by FY2023, the deficit ratio has to decline by 0.18 percentage points per year from the 2.5 percent ratio budgeted for FY2018b, ending at 1.64 percent in FY2023 (Figure 22).

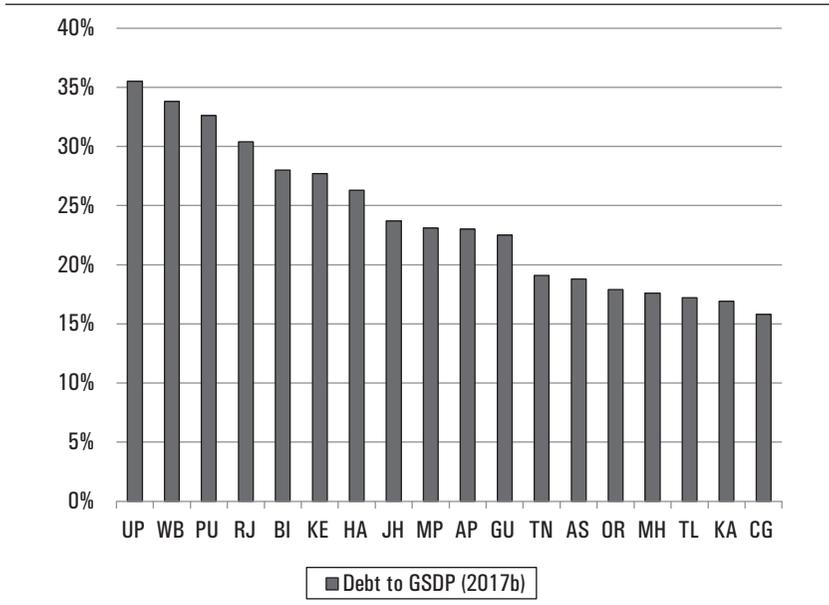
The nominal GSDP growth assumed here is 12 percent YoY. However, a lower GSDP growth rate, as happened for several states in the last five years (i.e., FY2012 to FY2017), would need a steeper fiscal correction to achieve the anchor target. On the other hand, the GSDP of states like Bihar (16 percent), Madhya Pradesh (15 percent), Andhra Pradesh (14 percent), West Bengal (13 percent) and Gujarat (13 percent) grew at above the 12 percent threshold. Karnataka undertook a major GSDP revision in FY2016 which boosted its GSDP by 39 percent (relating to accounting for its IT Services), which helped bring down its ratios too.

FIGURE 22. State Debt to GDP Ratio on FRBM Committee Guided Path



Sources: FRBM Review Committee Report, Credit Suisse estimates.

FIGURE 23. Unclear if the State Debt to GDP Target Is to Be Met Collectively or Individually



Sources: RBI, Budget documents, Credit Suisse estimates.

Note: State abbreviations on the x-axis are expanded in the Appendix.

Not only do the fiscal deficit ratios vary between states, but there is also significant variation between the debt to GSDP ratios of the states (Figure 23). It is unclear if the state debt to GDP target set by the FRBM Review Committee is to be met individually or collectively, that is, if every state should be individually or collectively below the target. Given the distribution of current debt ratios, it appears unlikely that the Committee meant that states must individually adhere to the 20 percent debt to GSDP ratio. If that were so, their collective ratio would be well below the anchor.

Among the major states, only Maharashtra had a fiscal deficit lower than 2 percent in FY16. Moreover, as discussed earlier, indebtedness varies across states, and the targets may need to be steeper for some, and easier for others.

That said states are not mandated to accept the FRBM Review Committee recommendations. Just as FRBM Act at the Centre was followed a few years later by state governments, this Committee's recommendations may be followed with a lag. The Centre used the refinancing of state debt in 2005 as an opportunity to get states to agree to adoption of the FRBM targets. UDAY

was used to induce the states to agree to adding losses incurred by the State Electricity Boards to fiscal deficits starting FY2021. Such an opportunity can be utilized to encourage the states as well to adopt second generation fiscal targeting requirements.

5. Summary of Findings and Conclusions

The importance of state governments in the economy has increased in the past few years: their combined spending is 18 percent of GDP in FY2018b versus just 14 percent in FY2012. From spending 6 percent more than the Centre in FY2011, the states are budgeted to spend 87 percent more than the Centre in FY2018b. The significant increase in Central transfers to states is well understood, as is the fact that states also had larger fiscal space created by nominal GDP growth even as the fiscal deficit ratio remained below 3 percent. But it is not as well-known that the states' own taxes have funded more than a third of the ₹19 tn increase in expenditure in this period. In recent years, the forces driving the divergence in expenditure growth between the Centre and states seem to be waning: the gap in growth rates in FY2017r and FY2018b is smaller.

There has been much concern in the past year over the profligacy of state governments undoing the fiscal contraction at the Centre. Bond traders as well as the forward-looking economic commentators have been surprised by the rising share of SDLs in government bond issuance: in FY2018b states may issue as much as 80 percent of the bonds issued by the Centre. While the pick-up in state fiscal deficits has indeed slowed down improvement in the general government deficits, we find that the reality is less worrying.

Under provisions of Article 293(3) of the Constitution, states cannot borrow without the Centre's permission, and thus the latter can enforce fiscal deficit targets. Instead of the deficit being the independent variable, derived by subtracting expenditure from revenues, in reality the states' expenditure is derived as a sum of receipts and the prescribed fiscal deficit.

Challenges, however, remain on state taxation: there appears to be a significant unexploited potential for tax collection even in the taxes administered by state governments. Most of the improvement in state taxation seems to be on VAT, which contributes to 60 percent of own tax revenues, and this too has seen rate increases across most major states. States have also benefited from windfall gains as rising retail fuel prices boosted ad-valorem taxes.

They appear to have been lax on both non-VAT taxes (like property tax), as well as on non-tax revenues: the shares of both of these in own receipts

have been falling steadily over the past three decades. Moreover, the non-VAT taxes and non-tax revenues are also much more concentrated in a few states, indicating insufficient penetration. Even within VAT, 40 percent is collected on petroleum products and alcohol (the reason why state governments have been reluctant to include these in GST). Recent attempts by Telangana to use receipts from land sales have not seen much success due to conflicts on land titles and other legal issues, but indicate some fresh thinking. Perhaps the perceived lack of flexibility post-GST can push state governments into levying more innovative taxes.

Growth in state government bond issuance should slow down going forward, but the absolute quantum is likely to stay similar to that of the Centre. The policy apparatus needs to adjust: while Central borrowing is carefully scheduled to avoid crowding out in the second half of the financial year when private credit demand picks up, that now needs to be applied to state borrowing too.

While one cannot deny that many areas that are state subjects, like urban infrastructure, irrigation, state highways and drinking water, are in need of substantial capex, we find that states that have higher revenue expenditure shares are also more productive. While causality here is likely bi-directional, it cannot just be a coincidence that all states with small governments have below average per capita GSDP, and vice versa, with only a few exceptions. This we believe is because governments in India are of sub-optimal size, in everything from policing to teaching: in under-sized governments increase in revenue expenditure can sometimes be more productive.

Capex is 17 percent of FY2018b spending, lower than the all-time high of nearly 20 percent in FY2016, but still among the highest seen in the last three decades. The ratio varies significantly: from less than 10 percent in Kerala to nearly 25 percent in Telangana. Most states that have below average capex ratios, like Kerala, Maharashtra and Tamil Nadu have above average per capita GSDP.

Our analysis suggests that the apprehension that the focus on social spending could be lost as the baton was handed over to the states seems to be misplaced. Revenue spending on education has risen to ₹4.9 tn (2.9 percent of GDP, up from 2.0 percent a decade ago), and social welfare spending has also climbed to ₹2.7 tn (1.6 percent of GDP). The per-student expenditure is too low and the pupil–teacher ratio too high for states like Uttar Pradesh and Bihar, despite their spending 4–5 percent of GSDP on education, demonstrating the fiscal challenge of raising productivity in the economically weaker states.

We find that the share of interest cost in overall expenditure is disconnected from the indebtedness of the state (debt to GSDP ratio). This is mainly

because the economically weaker states have a higher expenditure to GSDP ratio, as a larger part of their receipts is from the Centre. This may also be another reason for the lack of a correlation between a state's indebtedness and its borrowing cost. At an aggregate level, interest costs are now 10 percent of the total expenditure (19 percent in FY2005), a three-decade low. Debt to GSDP has risen in the last two years due to UDAY but a debt trap is unlikely except for a few states.

Despite the implementation of pay commission recommendations periodically, the share of salaries in total expenses has been falling steadily, and is not a ground for concern. Pensions, on the other hand, are rising very rapidly, particularly as the number of retirees grows. Lack of data prevents us from assessing future pension liabilities, but this can be a significant risk for state budgets. While only four states have so far implemented the 7th Pay Commission recommendations, and two more are planning to do so in FY2019, increases so far have been lower than seen in the 6th Pay Commission, and may not be as debilitating to state budgets as feared.

All put together, the combination of non-discretionary expenditures like salaries, pensions and interest costs is at a worrying level only for a few states like Punjab and Kerala.

We also find that the budgeting accuracy of state governments is weak, and has been worsening in the last few years: for three consecutive years, that is, FY2013-15, final state expenditures were lower than budgeted by more than 1 percentage point of GDP. Uncertainty around Central transfers had increased meaningfully in those years, as the Centre's attempt to consolidate fiscally had caused payments to get pushed out to subsequent years. This is exacerbated by the timing of these transfers: a large quantum is due in the last month, creating unnecessary volatility. States' own taxes have also been lower than budgeted by up to 0.5 percentage point of GDP in recent years, from being higher than budgeted in the years before that. States therefore, taking advantage of cash accounting, end up pushing out all types of expenditures, including salaries for teachers and doctors.

We also assessed the following recent developments that can have a meaningful impact:

GST: About 40 percent of India's tax collection will now be through GST. Our analysis suggests that the compensation formula is too generous. The states may therefore end up with more revenues than they may have expected earlier. The distribution of these taxes between states is much harder to assess: much of the analysis so far has focused on CST, but in our view it is the state-wise distribution of taxable

services that will affect net impact state-wise. For the next five years though, the promise of compensation provides revenue certainty to the states and stability to the budget forecasts.

Loan Waivers: Several more states are likely to be forced to announce these, in addition to the four that already have: Uttar Pradesh, Maharashtra, Punjab and Karnataka. We estimate that the final quantum could be ₹1.5 tn, spread out over 4–5 years, and the impact on any given year’s fiscal deficit may not be more than 0.2 percent of GDP. Given the control that the Centre has on state borrowings, we believe loan waivers are a problem of expenditure quality rather than quantity, and should not affect deficits. As they take time to implement, in the interim credit availability for farmers in these states could also be a problem.

FRBM Review Committee: In the general government debt anchor of 60 percent to be achieved by 2023, the Committee expects a ceiling of 20 percent for the states. It is unclear if this anchor is for the states collectively or individually: if the latter, the hurdle rate would be very high for most: many have debt to GSDP well above the threshold. The states’ aggregate fiscal deficit must decline by 0.18 percentage point per year from the 2.5 percent budgeted for FY2018b, ending at 1.64 percent in FY2023.

However, the states are not mandated to accept the FRBM Review Committee’s recommendations, and it could be a challenge for the Centre to get them to update their fiscal framework with second generation fiscal targeting.

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Appendix: State Name Abbreviations Used in the Paper

Code	State Name	Code	State Name	Code	State Name
AP	Andhra Pradesh	KA	Karnataka	RJ	Rajasthan
AR	Arunachal Pradesh	KE	Kerala	SK	Sikkim
AS	Assam	MP	Madhya Pradesh	TN	Tamil Nadu
BI	Bihar	MH	Maharashtra	TL	Telangana
CH/CG	Chhattisgarh	MN	Manipur	TR	Tripura
GU	Gujarat	ME	Meghalaya	UP	Uttar Pradesh
HA	Haryana	MZ	Mizoram	UT	Uttarakhand
HP	Himachal Pradesh	NA	Nagaland	WB	West Bengal
JH	Jharkhand	OR	Odisha	DL	NCT Delhi
JK	Jammu and Kashmir	PU/PB	Punjab	PO	Puducherry

Comments and Discussion*

Indira Rajaraman

13th Finance Commission

The paper is in three parts. The first section is about aggregate state deficits, the second is about inter-State variations in the composition of expenditure, and the final section, which I thought was the best section in the paper, looks at GST very carefully and at farm loan waivers. The message of the third section, indeed of the whole paper, is to soothe financial markets. I agree with that message, but where I depart from the authors is in the reason why they reach that conclusion. I think they have missed a very important feature of the fiscal framework in which State Governments in India function.

Let me pick up on some of the sentences in the paper: “There has been much concern if not alarm in the past year on the profligacy of State Governments undoing the fiscal contraction at the Centre” and the authors add the soothing note, that “the reality is less worrisome”. Then they say, there is not enough of a yield spread between States and so the markets are not going to “discipline” the States, and again there is a sense that State Governments in India are functioning in a fiscal framework where the deficit is a freely determined residual. The first section begins with expenditure, followed by revenue, and then deficits as the residual. The deficit is a freely determined residual: if States are profligate, then that will reflect in their deficits.

States don’t function in that kind of a fiscal framework in India. Article 293(3) of the Constitution mandates that State borrowings on financial markets will be subject to approval by the Centre. Any bonds States float can only be issued by the Reserve Bank of India, as the issuer of public debt, if they carry the formal approval of the Centre. This provision of the Constitution was made formal in 2006 by the passage of the Government Securities Act. The standard operating procedure under that Act formalized prior approval by the Centre before issuing any State debt. So, any issuance of State securities has necessarily had the approval of the Centre.

* To preserve the sense of the discussions at the India Policy Forum, these discussants’ comments reflect the views expressed at the IPF and do not necessarily take into account revisions to the conference version of the paper in response to these and other comments in preparing the final, revised version published in this volume. The original conference version of the paper is available on www.ncaer.org.

So how does the Centre approve state borrowings? How does the Centre determine the borrowing entitlements of States? This has varied over time. There was one dispensation that held until 2005, but I won't deal with that. In 2005, the 12th Finance Commission introduced an incentive for States to enact fiscal responsibility legislation, which all but two States responded to immediately. This fiscal legislation fitted a common template that required reduction of individual State deficits to 3 percent of the State Domestic Product (SDP), and therefore, in aggregate, to 3 percent of the aggregate of SDPs of all States. However, because SDP is measured at factor cost, and national GDP is measured at market prices, this meant that States were effectively held to 2.5 percent of national GDP at market prices. So, when the paper says that the right to borrow has been split evenly between the Centre and States, that is, at 3 percent of GDP, that is not so. States in fact are being held to a cap of 2.5 percent of national GDP, which is 3 percent of their individual SDPs. If we wanted to pull them up to 3 percent of national GDP, we would have to give them an individual limit of 3.6 percent of their SDP. This is an approximate average; the ratio of the factor cost (basic prices in the revised series) aggregate to that at market prices can clearly vary across years.

But there have been huge differences in the manner in which this provision was operationalized during 2005–10, during 2010–15, and in the period after 2015. The Ministry of Finance at the Centre conveys approved state borrowing limits to the RBI as absolutes in rupees crores, whereas the legislated fiscal limit of each State is stated as a percentage of their GDP. This means that how GDP is projected will determine how that absolute entitlement is set. During 2005–10, the Ministry of Finance simply prescribed the borrowing entitlement for every year of that five-year period right at the start in 2005, based on the projections of GDP by the 12th Finance Commission. So, towards the end of that period, some fast-growing States like Haryana were being confined to a borrowing entitlement of 1 percent of their actual SDP. It was 3 percent of their projected SDP, but it wound up being 1 percent of their actual SDP because they had performed so well and grown much faster than the rate projected.

So, it was not that States like Haryana wanted to be fiscally conservative during this period, but they were forced to do so. So, absurd conclusions can be drawn by looking at observed state deficits if we also don't look at the formula that determined those deficits.

During the years 2010–15, the 13th Finance Commission, of which I was a member, tried to tweak the formula that was used, so that the final SDP of a State in year N projected in year N-1 would be a closer approximation to the likely SDP in year N rather than a projection done two or three or five

years earlier. That did work, which is why over the period 2010–15, there was a rise in the aggregate State borrowing from nearly 1 percent in fiscal year 2011 to 2.5 percent. Therefore, the formula determines the outcome, not state conservatism or profligacy.

The reason why in the period 2005–10, the aggregate State deficit was so jagged was that after the global crisis of 2008, the state borrowing entitlements were loosened and then tightened. Thus, the aggregate State deficit went down up to 2008, then it jagged up, and then went down again.

What about post 2015? Figure 6 in the paper nicely shows that aggregate state deficit, with UDAY excluded, is just a little above 2.5 percent of GDP, which can be accounted for by the leeway given by the 14th Finance Commission. So, State level deficits should not be treated as freely determined in a state level fiscal framework. They are governed by a formula at the Centre that has varied over time.

Getting back to the message for markets, the authors say GST and farm loan waivers are not so bad, and try to soothe financial markets, which according to them have been spooked by the rise in issuance of state bonds. Actually, the existence of the formula is what should allow markets not to worry. We are not a Brazil, we are India and sub-national governments are controlled. This is what the market should be taking solace from.

There are nonetheless two things that are very worrying. One is the 7th Pay Commission salary scales, and the other is the march of pensions that had started even before the 7th Pay Commission. They are causes for worry, not because they will lead to high deficits, but because routine expenditures are going to be badly squeezed, and we are going to find schools without teachers and primary health centers without medicines.

Finally, a quick point on the bulge in non-tax revenues in Figure 5 in the period 2005–10, which coincided with the 12th Finance Commission. In this period, there was a restructuring of state debt owed to the Centre. When this is done, the restructuring is treated as though the debt has been repaid to the Centre, with a return flow from the Centre of net non-tax revenues. In Figure 5, this is where the bulge between 2005 and 2010 in general non-tax revenue comes from. So, we need to be very careful in interpreting these figures.

Rathin Roy

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I think this is an excellent paper. NIPFP has been doing an annual meeting on State Finances for the last three years, but we have restricted participation because we want State Finance Secretaries and others who are the real

clients to speak freely. If markets analysts are taking up to this next step of looking at state finances, that is good.

Dr Rajaraman made the point regarding Article 293 which causes a huge problem in doing macro fiscal analyses of the States. This is tempered somewhat by the fact that after the 14th Finance Commission, a conversation has been happening with the Finance Ministry on ways in which these limits are set, and the 14th Finance Commission also allowed some flexibility. So, if you start with the 14th Finance Commission, then the endogeneity of Article 293 becomes somewhat less of a problem.

One important feature of fiscal consolidation by the States is that they have collectively ceased to run revenue deficits, and this does not come out in the paper. The paper focuses a lot on the virtues of revenue expenditure, but the point is whether revenue expenditures are tax financed or not. The Centre has not done it and for reasons we have elucidated in the FRBM Report, we do not expect the Centre to do it for another 5–7 years. So, this is a virtue that the States have inculcated, and I think it needs to be taken account of.

For instance, if you take the State of Uttar Pradesh, the very fact that it has not been fiscally profligate and has been running reasonable revenue surpluses over time has permitted it to increase revenue expenditures, including on education. So, there is an important link between the States that are actually running revenue surpluses and their capability of raising expenditures on public goods.

On the calendar issues, the RBI is the banker to both the Centre and the States. The Centre has a very clear banking calendar. If both the Centre and the States were to come looking for loans at the same time, everyone's cost would go up. Hence, the States come second in this and the Centre comes first. However, to moderate that, there is a process of 'ways and means advances' (WMA), which is fairly accommodative in allowing States to manage their short-term cash flow needs consistent with the expenditures they want to undertake.

Is it a matter of genuine concern that state expenditures are going up relative to the Centre? Central public investment has been a fraction of State public investment. Most of the Central public investment goes into financial investment, not into gross fixed capital formation. Since they have curbed the revenue deficits, the States are also now major players in revenue expenditures. What does the Centre do? It oversees law and order, some defense, it runs a railway, and does some merchant banking. But the Central Government is not a major player in the delivery of public goods. That calls for the State Government spending to rise, so this should not be surprising.

As regards the point that you made on the States collectively under-spending on police, you need to control for that by noting the fact that Central expenditure on paramilitary forces has gone up.

On the Pay Commission, the States have always been extremely strategic in implementation, and have shown incredible fiscal fortitude in not increasing salaries. In the 7th Pay Commission Report, we have given 9–10 reasons why we don't think that the Pay Commission would be such a burden on the States, with some exceptions, Punjab, Kerala, and increasingly, Maharashtra.

I think the point the paper made about the farm loan waiver is very important. Farm loan waivers are bad things for other reasons. But their fiscal impact on State finances will not be of great magnitude.

My final point is on the fiscal deficit path, which is discussed in the FRBM Report on page 95. We worry about the fact that the States will have to go down from where they are now to approximately 1.7. That is happening because the incremental debt burden of the States is expressed in the form of a high primary deficit as interest payments have been falling. This problem is really worrisome. But, what we have said is that, if States collectively make just a 0.16 reduction in the fiscal deficit each year and are given a long time to make this reduction, it would result in the Centre falling fast, the States actually increasing slightly, and then falling to a point where their debt–GDP ratio will be 21 again, which was the FY17 level. The 15th Finance Commission will have to decide on the distribution of that adjustment among States, which is a complicated issue, and will require conversations with the States.

General Discussion

Rohini Pande started by relating the discussion, especially by Indira Rajaraman, back to the references to command and control in the first session. She pointed to distortionary agency activities by state bureaucrats or politicians arising out of their mandate to adhere to formulae and blanket rules used for transfers. She urged the authors to analyze what the States and the Centre do to account for shocks such as a too high or too low monsoon in any single year. Overall, she felt it was important to think of ways of financing that are not formula-based.

Vijay Joshi cited the reference to the European Union (EU) and how the bond market does not enforce credit discipline on the EU nations. In India too, credit discipline is enforced by the Central Government in accordance

with the constitutional provision. It needs to be examined whether this system works well enough or changes are needed in how it should work.

Suman Bery raised the issue of the fiscal monetary mix, and questioned how the aggregate state borrowing and Central Government borrowing should be seen in the context of the Statutory Liquidity Ratio (SLR) and other related subjects. This would help get a sense on whether the bond market as a whole is playing any price discovery role.

Govinda Rao stated that the Reserve Bank of India does not analyze expenditures and revenue, which makes it incumbent upon the States to deal with such issues, especially relating to revenue generation from lotteries, and departmental public enterprises, and roadways like the Punjab Roadways that are run by individual States.

He also noted that until 2005–06, money from all the centrally sponsored schemes used to go to the States, but from 2006 to 2014, this money started going to implementing agencies. From 2014 onwards, thanks to the Rangarajan Committee Report, the government stipulated that the money should pass through the State budgets. So all these changing fiscal transfer mechanisms need careful adjustment in the data or else we can get a misleading picture. This is not easy. Careful attention has to be paid to the fiscal plumbing within the States. He also stressed the need to be careful in comparing the supposedly sharp increase in tax devolution by the 14th Finance Commission from 32 percent to 42 percent. When proper adjustments are made, it is more like 39 percent to 42 percent, a much smaller increase. He concluded by noting that apart from loan waivers, the move to prohibition by several States will pose fiscal risks.

Mihir Desai wanted to check the nature of the backup guarantee provided by the Centre on State Bonds, and if it is implicit, then whether it has ever been tested. Second, he worried that though he understood the key message of the paper that we should not worry, he was not at all sure of the reasoning. If expenditures and taxes were both shifted to the States, then he could see the reasoning since the balance sheet of the Centre was being substituted for the balance sheet of the States, leaving aside the issue of poorer states and how they would be helped to develop faster. However, the narrative is that the expenditure has been pushed to the States, but taxes have not kept up, so that there was a strong decoupling of taxation and expenditure, expenditures at the state level, and taxation not keeping up with that. This requires discipline, and Dr Rajaraman said that India is not Brazil and we have rules and formulas. But there can be lots of political economy reasons that make this decoupling problematic. And on top of this, there is no discipline from bond markets.

Alluding to the suggestion that the bond market does not impose any discipline, Rajnish Mehra said that this could imply an implicit bailout by the Centre, which means that in case of a default, this would be a risk-free asset, irrespective of the level of debt. He also queried why the market does not impose any discipline on the bond market in case of private placement of bonds with government agencies and others.

Indira Rajaraman wanted to know what drives the yield spread on State bonds. She contended that the yield spread has actually widened in recent years, and is probably much wider now than it has ever been precisely because of the increase in non-commercial bank, and non-SLR participation. Moreover, along with the SLR, there is a Held-to-maturity (HTM) requirement. Over the years, the HTM has been increasingly brought down, which points to greater play for the market, leading to a rise in the inter-state yield.

She said that the key questions which need to be addressed are why the yield spread is low, and why the market is apparently willing to lend to the States of Haryana and Jharkhand on roughly equal yields. She stated that the RBI is a banker to both the Central Government and to State governments, and it conducts the issuance and servicing of bonds through an automatic debit mechanism whereby these bonds are first serviced before any other expenditures are entertained. This acts as a yield reducer and also makes these bonds essentially risk-free.

Rathin Roy remarked that if the Centre asked the States how much they wanted to borrow, the States would say, as much as we can, and not that we would like to borrow for this or that. There may be problem in the articulation of the rule, but they avoid conflicts of interest and allegations of favoritism in such a system, and here the Finance Commission is the right place for framing these rules. He concluded by agreeing with the authors that the markets assume that State government debt is better than Central Government debt and the lack of a yield spread reflects that.