STUDY OF STATE FINANCES

WORKING PAPER

May 2020

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GLOSSARY OF TERMS

Capital Expenditure is expenditure that is used to create assets or reduce liabilities. This could be in the form of roads, schools, hospitals, and other infrastructure or by paying back loans taken.

Capital Receipts are receipts which lead to a decrease in assets created such as through sale of assets or a decrease in liabilities through the receipt of money from loans or other borrowings.

Committed Liabilities typically include expenditure on salaries, wages and pensions, and interest payments on loans. State governments are obliged to pay them even if they face a resource crunch.

Devolution of Union Taxes denotes the taxes collected by the Union government that are shared with the State governments in accordance with the recommendations of the Finance Commission. The Union taxes devolved to states are untied funds, and States can spend them according to their local priorities.

Fiscal Deficit is the gap between total expenditure requirements and total receipts, excluding borrowings. It shows the amount considered necessary by the government to meet its expenses and equals the money the government will need to borrow to meet its expenses. A large fiscal deficit means a large amount of borrowings.

Grants-in-Aid are payments or assistance given by one government to another government, body, institution or individual, usually for a specific purpose. In this report, we look at the Grants-in-Aid specifically from the Union Government to States in the form of Finance Commission Grants, Centrally Sponsored Schemes, and Other grants.

Outstanding Debt is the stock of money borrowed by subsequent governments over the years which the government currently owes.

Receipts indicate the money received or earned by the government. There are broadly two types of receipts: Revenue Receipts and Capital Receipts.

Revenue Expenditure is expenditure incurred to meet the day-to-day and regular needs expenditure of the government and does not result in the creation of assets nor yields any revenue in future. It includes components such as salaries, pensions, subsidies, and administrative expenses.

Revenue Deficit is the gap of the government's total revenue receipts to its total revenue expenditure. It shows the degree to which the government will need to borrow to finance its revenue expenditure.

Revenue Receipts are those receipts that need not be paid again to the payee from the government and do not impact the liabilities of the government. For States this includes money earned or received through tax and non-tax sources including income from dividends, and money received from the Union government.

Ways and Means Advances are temporary loan facilities provided by the Reserve Bank of India to the Union and State governments in case of short-term mismatch in cash flow of receipts and payments.

KEY FINDINGS

Our salient findings from the analysis of revenue and expenditure patterns for the sampled States are the following:

UNION AND STATE REVENUES

- From the years FY 2017-18 to FY 2019-20 Revised Estimates (REs), per-capita revenue receipts registered an increasing trend. Budget estimates (BEs) for FY 2020-21 anticipated a further rise. These, however, are likely to be significantly lower in the REs of FY 2020-21 due to the impact of COVID-19.

- States are dependent on the Union for their revenue receipts. On average, only around half of the revenue receipts of States are drawn from Own Source Resources. For some States, the proportions are significantly lower at 22 per cent (Bihar) and 13 per cent (Mizoram).

- The adoption of the 14^{th} Finance Commission recommendations increased the tax devolution from 32 per cent to 42 per cent. Consequently, the share of tax devolution out of State's total revenue receipts rose to nearly 30 per cent for the 2015-19 period; however, according to REs for FY 2019-20, this proportion has fallen to 24 per cent. Further, for FY 2020-21 BE - the first year of the 15^{th} Finance Commission - this proportion is estimated at 26 per cent.

- Levying cesses counterbalances the devolution of taxes from the Union to State governments as cesses are not part of the divisible pool of taxes. The introduction of the Goods and Services Tax (GST) has been accompanied by an increased charging of cesses, which now comprise 15 per cent of gross tax revenue.

- Additionally, the estimated 12 per cent growth in tax revenue targeted by the Union government for FY 2020-21 BE as against 4 per cent in FY 2019-20 RE would look more challenging in the current scenario. Therefore, the actual tax devolution to States for FY 2020-21 BE is expected to be much lower than the estimated ₹7.8 lakh crore.

GRANTS-IN-AID TO STATES

- Grants-in-Aid (GIA) from the Union government have undergone changes owing to the coming of the 14^{th} and 15^{th} Finance Commissions and restructuring of Centrally Sponsored Schemes (CSSs). Presently, GIA are disbursed to State governments under: Finance Commission Grants, CSSs, and Other grants and transfers.

- While the overall quantum of funds through CSSs has declined for many States, they still constitute a significant portion of States' revenue. Moreover, decrease in Union GIA to States through CSSs was accompanied by an increase in States' share of CSS budgets. For some States, this resulted in an increase from 25 per cent as State share to as high as 40 per cent or 50 per cent. This has had an impact on the States' flexibility by eroding into their untied funds which are then funnelled back into CSSs.

POLICY CHANGES

- GST compensation disbursements from the Union to the States have witnessed a shortfall. These are likely to see further downward pressure and non-timeliness of payments due to fall in GST collections and States' own revenue generation growth.
- Following the 15th FC recommendations, the total Union share allocated to the States for State Disaster Response Management Funds is ₹22,184 crore in FY 2020-21 BEs, 114 per cent more than the ₹10,344 crore provided for State Disaster Response Fund in the FY 2019-20 BEs.
- RBI announced a rise of 60 per cent in the drawing limit of Ways and Means Advances (WMA) for State governments – raising the limit to approximately ₹51,560 crore – to strengthen their ability to spend on health and welfare during the COVID crisis. However, the raised limit continues to fall short of the State borrowing requirements, implying that States would need to resort to market borrowings to finance expenditure. Further, WMA borrowings are to be paid back in 3 months and these short-term facilities may prove insufficient in the current economic climate.

EXPENDITURES

- Most States undertake a considerably higher revenue expenditure (70-80 per cent of total expenditure) as compared with capital expenditure (20-30 per cent). A substantial segment of revenue expenditure is in the form of committed liabilities – such as salaries, pensions and interest payments – that States are required to pay despite resource constraints.
- The change in composition of Union transfers to more untied forms (i.e. increase in tax devolution) and reduction in funds through CSSs was met with a fear that States would decrease their funding for the social sector. However, for most States, social sector expenditures increased in quantum and have remained constant as a proportion of the GSDP. Worryingly, however, many States had anticipated a fall in total expenditures including social sector expenditures in FY 2020-21 BE. This, though, is likely to change due to the pandemic and will require additional mobilisation of resources.
- Healthcare expenditure is primarily focused on medical and public health services – this component has grown steadily over time. Majority of healthcare spending is on the revenue account, leaving fewer resources for capital expenditure. However, given that most States do not meet prescribed requirements of healthcare infrastructure, health capex should not be forfeited.
- The analysis of States' revenue and expenditures shows that even prior to the COVID-19 pandemic, public finance in India was in a precarious situation. States are at the forefront of managing the socio-economic consequences of the COVID-19 crisis, and safeguarding welfare measures for citizens. It is, therefore, imperative that the Union government creates a medium-term plan for resource mobilisation and economic revival, and ensures adequate resources are transferred to States in a timely manner.

SECTION 1

1. Introduction

The recent COVID-19 crisis has placed enormous fiscal burden on the Union and State governments. The nationwide lockdown and social distancing steps imposed have exacerbated the ongoing economic slowdown. The impediments to production and consumption activities will be accompanied by a decline in tax revenues.

The State List mentioned in the 7th Schedule of the Constitution entrusts significant expenditure responsibilities on States. Yet significant revenue raising abilities rests primarily with the Union government. States' revenues largely come from indirect taxes on transport fuel, vehicle sales, alcohol, real estate transactions, and electricity. Most of these economic activities have either come to a complete halt or have reduced drastically in the past two months. In comparison, the Union government largely relies on direct taxes on personal and corporate income, manufacturing, and imports. The consequences of these economic pressures are particularly worse at a time when the government needs to engage in fiscal expansion to step up healthcare and social protection measures to combat the disease, ensure adequate livelihoods, and to restart the economy.

Four recent changes in India's fiscal architecture have further placed the States' finances in a precarious position. First, the introduction of the Goods and Service Tax (GST) under which States transferred a significant part of their taxation powers to the Union government, thereby eroding their ability to raise their own revenues.

The GST regime includes a provision wherein the Union government compensates States for a loss in revenue from the change in taxation systems for the first five years. Assuming a growth rate of State GST revenues (SGST) of 14 per cent, a shortfall in tax collection below this estimated level is paid as GST compensation to the States by the Union. However, this new structure of compensation seems precarious. The compensation is disbursed from the collections made through a GST Compensation Cess - an additional levy on goods that attract 28 per cent GST. This is unlikely to be adequate amid the coronavirus crisis and would not be sufficient to plug the States' revenue gap.

Second, the restructuring of Centrally Sponsored Schemes (CSSs), in order to accommodate the increase in tax devolution to States to 42 per cent from 32 per cent recommended by the 14th Finance Commission. In October 2015, for several schemes including the National Health Mission, Rashtriya Swasthya Bima Yojana, National Rural Drinking Water Programme, Pradhan Mantri Awas Yojana, and the Samagra Shiksha, the Union government changed the funding pattern from 75:25 to 60:40 for General Category States, while the share remains unchanged at 90:10 for the North-Eastern and Himalayan States. Hence, part of the autonomy given to States in the form of increased devolution has been curtailed by the rise in States' contribution towards CSSs.

Anticipating a difficult economic situation, the Ministry of Finance (MoF) issued a notification directing several Ministries and Departments to curb expenditures in the first quarter of the current Financial Year (FY) 2020-21 (i.e. from April to June, 2020) to ease the government's fiscal burden.[1] Many Ministries have been asked to restrict their overall expenditure to 20 per cent of the Budget Estimates (BEs) for the year; several others may spend only up to 15 per cent of the BEs– these include the Ministry of Housing and Urban Affairs, Department of Social Justice and Empowerment, and the Ministry of Women and Child Development. While these steps have, in part, been carried out to repurpose expenditure towards COVID-related priorities, they will add uncertainty in the overall provisioning of CSS funds and are likely to escalate impact on State finances.

Third, even before the COVID-19 crisis, State finances had to adjust to other fiscal shocks constraining their finances such as the Ujwal DISCOM Assurance Yojana

(UDAY). Under the scheme, States were to take over 75 per cent of the DISCOM debt as on September 30, 2015, 50 per cent in FY 2015-16 and 25 per cent in FY 2016-17. Over the years, the scheme also requires States to fund greater shares in DISCOM losses to the tune of 10 per cent in FY 2017-18, 25 per cent in FY 2018-19 and 50 per cent in FY 2019-20.[2] Between 2015-17, as per the Reserve Bank of India (RBI) report on State Finances (2019), 16 States took over ₹2.1 lakh crore debt from their DISCOMS resulting in a significant rise in State debt.[3]

Finally, FY 2020-21 also saw the institution of the 15th Finance Commission and the submission of its first interim report in February 2020. Key aspects of the report dealt with an adjustment in the formula for devolution of taxes from the Union to the States, provision of Grants-in-Aid (GIA), proposal for sector-specific and performance-based grants, and recognition of challenges in GST implementation. How the new Finance Commission will determine Union-State fiscal relations is likely to impact the status of State finances.

In light of this context, we studied the revenue and expenditure performance of 17 States to unpack the status of State finances prior to the outbreak of COVID-19 with a view to envision the fiscal impact from the pandemic, and discuss possible ways forward for the States. The rest of the paper is organised as follows: Section 2 discusses the methodology adopted. Section 3 undertakes a discussion on different components of State revenue receipts, such as Own Source Revenues and Union transfers (including devolution of taxes and components of GIA). Section 4 analyses the impact of recent policy developments namely, the implementation of GST, and changes to availing Ways and Means Advances. Section 5 focuses on expenditure, beginning with a look at revenue and capital expenditure, followed by a discussion on developmental and social sector spending with special attention to health. Finally, Section 6 concludes and presents some key points for discussion.

This paper contains Revenue and Expenditure Performance of 17 States.

Quick access to the precarious situation of state finances prior to COVID-19 and its likely impact.

SECTION 2

2. Methodology

The present study on State finances assesses the flow of resources to State governments and their utilisation. Our sample focuses on 17 States that have released their State budgets in the public domain for the current financial year, FY 2020-21.[4] These are: Assam, Bihar, Chhattisgarh, Gujarat, Haryana, Jharkhand, Karnataka, Kerala, Maharashtra, Mizoram, Odisha, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, Uttarakhand, and West Bengal.

Data for the analysis of revenue and expenditure components was primarily sourced from State budget documents. The analysis of GST revenue receipts and compensation to State governments relied upon government data available in the public domain, primarily through press releases by the Press Information Bureau. The discussion on Ways and Means Advances was based on data from the Reserve Bank of India (RBI).

Budget Estimates (BEs) are the estimates put forth by the government for any department or scheme under various major heads for the upcoming financial year. During the year, based on an estimation of expenditures, States compute Revised Estimates (REs). These REs can be either lower than the BEs if actual expenditure till October or anticipated expenditure till March is expected to be less than originally budgeted or higher if the grants budgeted at the start of the year fall short of expenditure requirements. In the latter case, demands for additional grants are placed in front of the Parliament which are then looked into and passed by the Parliament during the financial year itself. Actuals represent the actual expenditures by the government in a given financial year. Since actual expenditures can be assessed only after the financial year has passed and are audited by the Comptroller and Auditor General (CAG), these figures are released by the government with a time lag of two years.

In this note, actual revenue and expenditure amounts have been presented for FY 2018-19 and prior years, REs for FY 2019-20, and BEs for FY 2020-21. Additionally, the analysis of GIA covers the 14^{th} and 15^{th} Finance Commission periods. The components of GIA from the Union government have undergone changes from FY 2017-18 owing to the removal of distinction between Plan and Non-Plan. Earlier Finance Commission (FC) grants were clubbed under Non-Plan grants, and instead of CSSs there were Central Plan Scheme and Central Assistance to State Plans (CASP). Other transfers were the remaining part of Non-Plan grants. To ensure comparability, we have considered Non-Plan components such as grants to local bodies, State Disaster Relief Funds (SDRF) and post-devolution revenue deficit grants under FC grants; and, other Non-Plan components such as National Disaster Relief Fund (NDRF), GST compensation and grants to cover gap in resources under Other grants and transfers.

SECTION 3

3. Revenue Receipts of the states

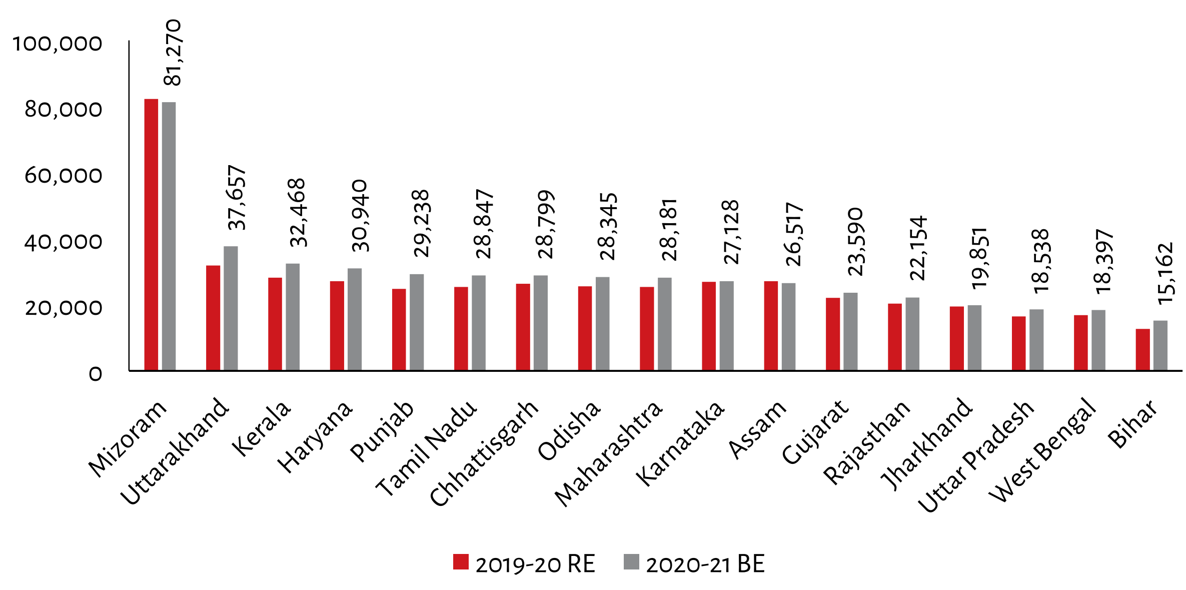
In every financial year, States estimate the revenues that could be earned in that particular year and plan their expenditures accordingly. With States being at the frontlines of the current COVID-19 crisis and having significant expenditure responsibilities, it is critical that they have the necessary revenues to meet their expenditure needs. This section looks at the revenue receipts of States in their most recent budgets, with a specific focus on the last two fiscal years i.e. FY 2019-20 RE and FY 2020-21 BE. The analysis is broken up as follows. First, we look at the per-capita revenue receipts of States and how these were expected to change in comparison to the expected rise in their per-capita Gross State Domestic Product (GSDP). This is then followed by a more detailed discussion on the different constituents of States' revenue receipts.

Per-capita Revenue Receipts

Per-capita revenues receipts or the revenue receipt generated per person in a State is calculated as the total revenue of a State divided by the population of that State. For population figures, we have used the recent projections by the Technical Group on Population Projections published by the Ministry of Health and Family Welfare.[5]

For the States analysed here, the average revenue per-capita for FY 2020-21 BE is ₹29,240. There are, however, significant differences across States. Mizoram has the highest per-capita revenue among the States analysed with ₹81,270, followed by Uttarakhand with ₹37,657, Kerala with ₹32,468, and Haryana ₹30,940. In contrast, per-capita revenues of Bihar were ₹12,662 for FY 2019-20 RE and ₹15,162 for FY 2020-21 BE.

Figure 1: Total Revenue Receipts Per-Capita for FY 2019-20 RE and FY 2020-21 BE



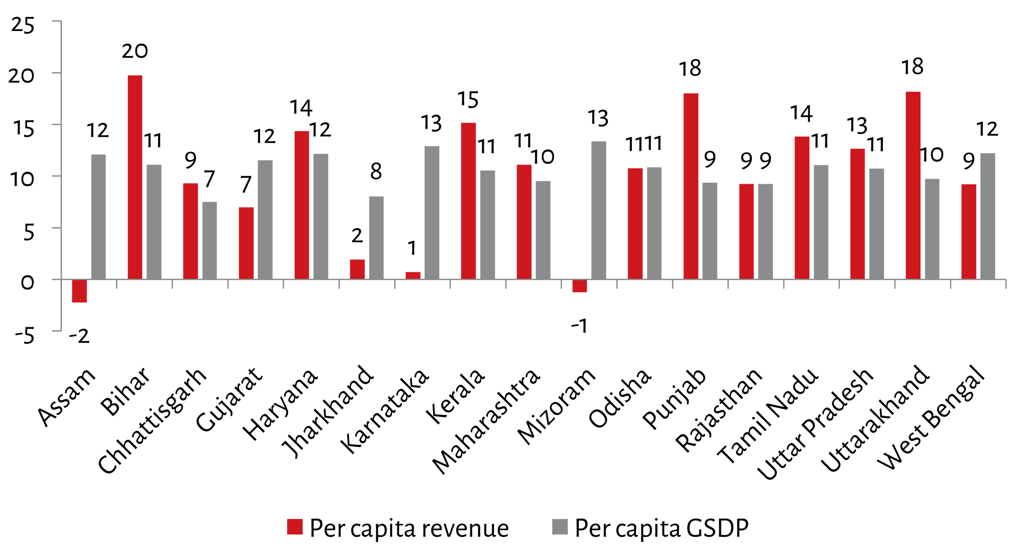
Source: *State Budget documents. Population projections obtained from Report of the Technical Group on Population Projections, Ministry of Health and Family Welfare: https://nhm.gov.in/New_Updates_2018/Report_Population_Projection_2019.pdf.*
Note: *Per-capita revenue figures in rupees.*

Comparison with the Pre-Capita GSDP growth rate

Between FY 2019-20 RE and FY 2020-21 BE, on average, per-capita revenue receipts were expected to grow at a rate of 8 per cent. States with a higher expected growth rate included Bihar (20 per cent), Punjab (18 per cent), and Uttarakhand (18 per cent). In contrast, growth rates were expected to be less than 10 per cent in Karnataka, Jharkhand, Gujarat, Chhattisgarh, Rajasthan, and West Bengal. Worryingly, States such as Assam and Mizoram indicate a negative growth in per-capita revenue receipts.

A comparison with growth in per-capita GSDP indicates that the expected increase in per capita revenue receipts was higher than the expected increase in GSDP for nine out of the 17 States analysed. These include Bihar, Chhattisgarh, Haryana, Kerala, Maharashtra, Punjab, Tamil Nadu. Uttar Pradesh and Uttarakhand.

Figure 2: Growth Rate of Per-Capita Revenue Receipts in Comparison to Growth Rate of Per-Capita GSDP between FY 2019-20 RE and FY 2020-21 BE



Source: *State Budget Documents. GSDP numbers from MoSPI. Population projections obtained from Report of the Technical Group on Population Projections, Ministry of Health and Family Welfare: https://nhm.gov.in/New_Updates_2018/Report_Population_Projection_2019.pdf.*

Past analysis of revenue receipt estimations of States, however, indicate that there are differences between the revenue receipts estimated and the actual revenue received or earned. In FY 2018-19 for instance, seven out of the 17 States - including Gujarat, Karnataka, Maharashtra, Odisha, Tamil Nadu, Uttar Pradesh, and West Bengal - had reported BEs to be 5 per cent higher than the Actuals for the year. In fact, Mizoram was the only State to report higher Actuals than BEs by 2 per cent.

What impacts the ability of States to estimate revenues accurately? The next sub-section looks at the break-down of the different forms of revenues available with States.

> With States being at the frontlines of the current COVID-19 crisis and having significant expenditure responsibilities, it is critical that they have the necessary revenues to meet their expenditure needs.

Composition of Revenue Receipts

Broadly, revenue receipts of States comprise revenue from own sources and transfers from the Union government, including devolution of taxes and Grants-in-Aid. This distinction on the nature of revenue receipts gains importance because although State governments do not have much influence over Union transfers, the States where revenues from own sources form a significant share of total receipts enjoy relatively more flexibility in financing their development needs. Thus, the ability of a State to respond to the COVID-19 pandemic may be impacted by the source of their revenues. The sub-sections below will look at each of these components in greater detail.

Own Source Revenues

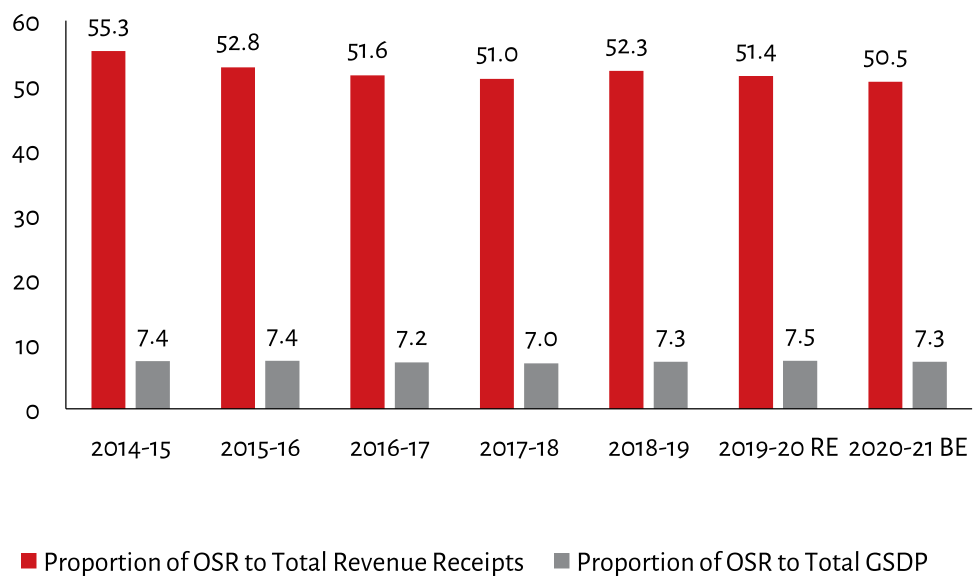
Own Source Revenues (OSR) comprise the tax and non-tax receipts of State governments. States' own tax revenue comes overwhelmingly from indirect taxes as the power to impose direct taxes rests with the Union government. Following the implementation of the GST - barring a few exceptions like petroleum products, property tax, and alcohol excise - indirect taxes have, to a large degree, been subsumed under the GST regime.

Non-tax revenue, on the other hand is the recurring income earned by the State governments other than taxes, such as interest payments (received on loans given by the State government to Railways, or to other States, etc.), and dividends and profits received from the public sector companies. Additionally, various services provided by the government, such as police and defence, social and community services, and economic services also yield revenue for the government.

From the perspective of States, the analysis illustrates that while around half of States' revenue is derived from OSR, it has seen a marginal decline over the years, indicating their increasing fiscal dependence on the Union government. For instance, in FY 2014-15, on average, OSR accounted for 55 per cent of total revenue receipts. However, FY 2020-21 BE, witnessed the lowest proportion of OSR out of total revenues at 50.5 per cent - over 4 percentage points lower than in FY 2014-15.

"Although State governments do not have much influence over Union transfers, the States where revenues from own sources form a significant share of total receipts enjoy relatively more flexibility in financing their development needs."

Figure 3: Proportion of OSR to Total Revenue Receipts and GSDP

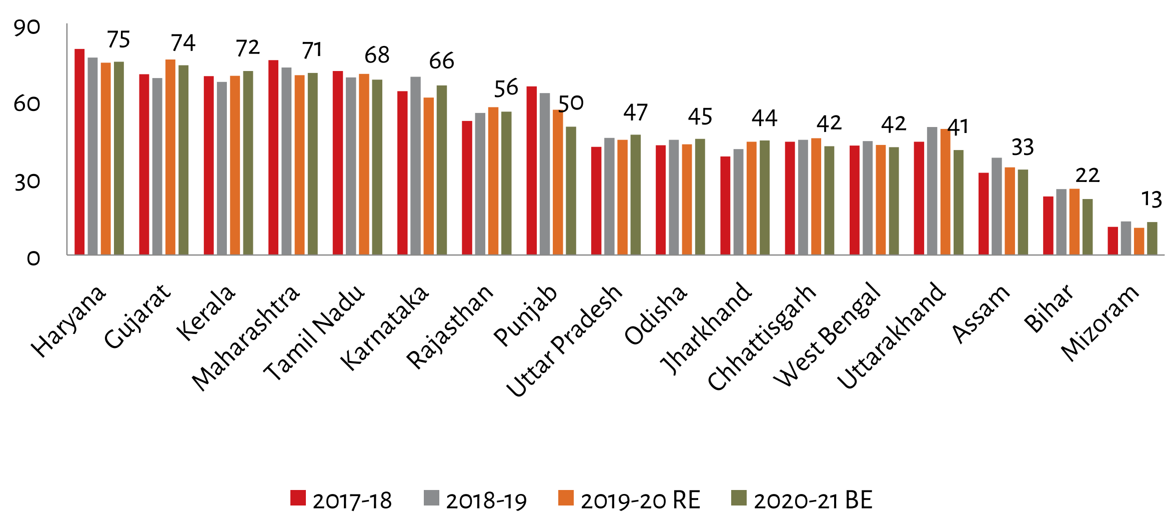


Source: *Own State Resources (OSR) and Total Revenue Receipts for FY 2019-20 based on Revised Estimates, and for FY 2020-21 based on Budget Estimates. GSDP in current prices. GSDP for 2019-20 and 2020-21 are projected figures from the Ministry of Statistics and Programme Implementation.*

A State-wise analysis of the same for our 17 States indicates that as per FY 2020-21 BE, the States with a higher share of OSR out of total revenue receipts were Haryana (75 per cent), Gujarat (74 per cent), Kerala (72 per cent), and Maharashtra (71 per cent).

In contrast, fiscally poorer States such as Mizoram, Bihar, Assam, Uttarakhand, West Bengal, and Chhattisgarh are more dependent on transfers from the Union government, with low share of own tax and non-tax revenues.

Figure 4: Own State Resources out of Total Revenue Receipts



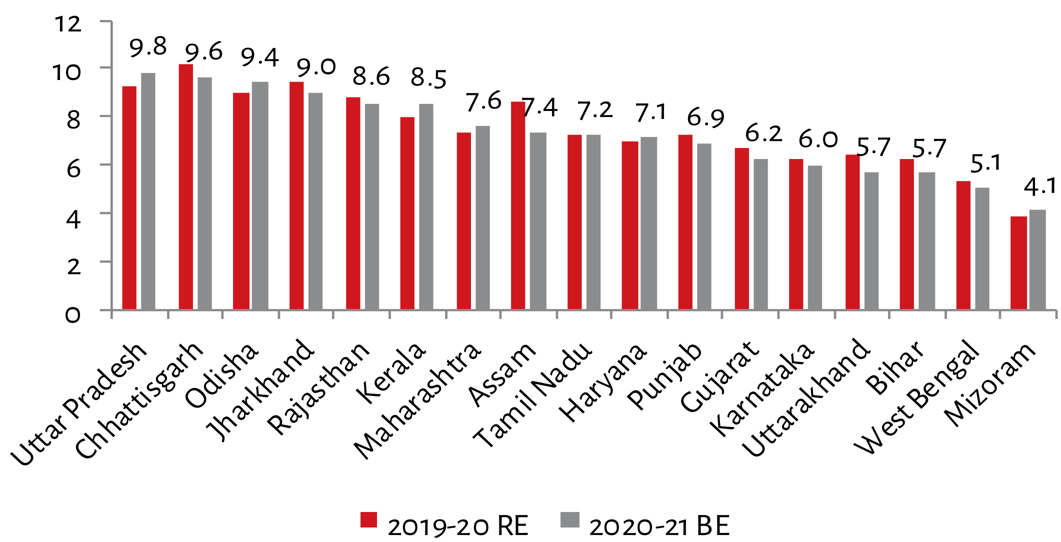
Source: *State Budget Documents.*

Proportion of Own Source Revenue (Tax and Non-Tax) to GSDP

It is also useful to look at OSR as a proportion of the States' GSDP as changes in the economic growth of a State can impact the revenue generated in the State. Higher this ratio, the better financial position of the State.

As can be seen in the graph below, in FY 2020-21 BE, States such as Uttar Pradesh, Chhattisgarh, Odisha and Jharkhand reported high OSR to GSDP ratio of around 9-10 per cent. In contrast, the ratio was less than 6 per cent in Uttarakhand, Bihar, West Bengal, and Mizoram.

Figure 5: Own Source Revenue as a Percentage of GSDP

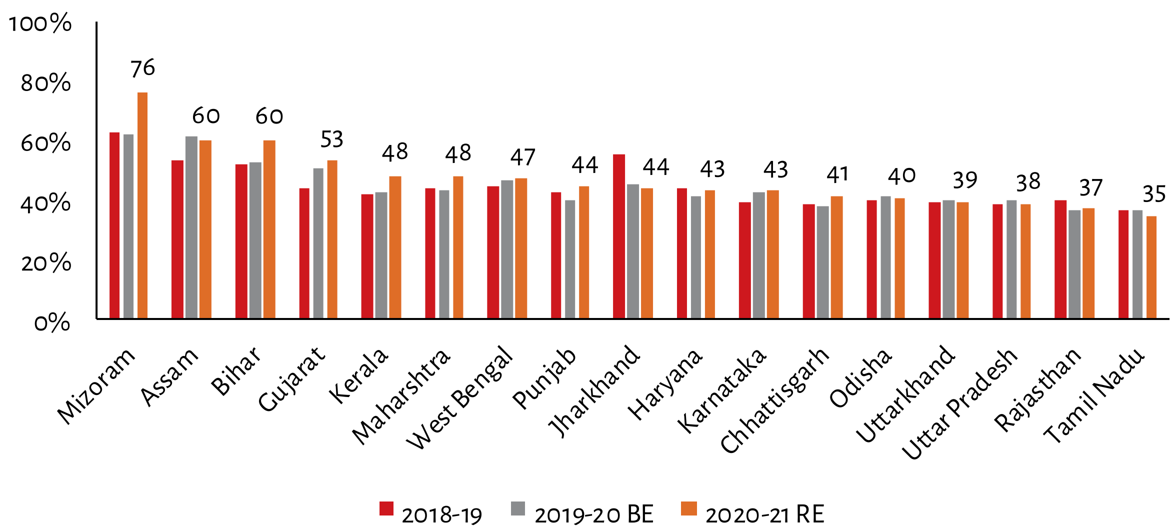


Source: *State Budget Documents; GSDP numbers from MoSPI.*

As previously mentioned, OSR comprises both own tax revenue and own non-tax revenue. Recent changes such as the implementation of the GST has resulted in a significant reduction in the ability of States to generate their own tax revenues. In FY 2020-21 BE, SGST was expected to account for nearly 47 per cent of States' own tax revenues from 45 per cent in FY 2019-20 RE, with a bulk of coming from non-essential goods such as electronics, fashion and entertainment, and essential goods such as food and personal care, all of which have been impacted by the COVID-19 crisis and the lockdown that has ensued. The contribution of SGST to own tax revenue is significantly higher in states such as Mizoram (76 per cent), Assam and Bihar with each 60 per cent. On the other hand, states such as Uttarakhand, Uttar Pradesh, Rajasthan, and Tamil Nadu depend on non-GST taxes such as sales tax, State excise, stamp duties and taxes on vehicle and electricity charges.

> “While around half of States' revenue is derived from OSR, it has seen a marginal decline over the years, indicating their increasing fiscal dependence on the Union government.”

Figure 6: SGST as a Proportion of Own Tax Revenue



Source: *State Budget documents.*

A comparison of the growth rate of own tax revenue and own-non tax revenue indicates that on average, States had anticipated a higher growth rate of own tax revenue at 12 per cent between FY 2019-20 RE and FY 2020-21 BE, compared to 5 per cent for non-tax revenue.

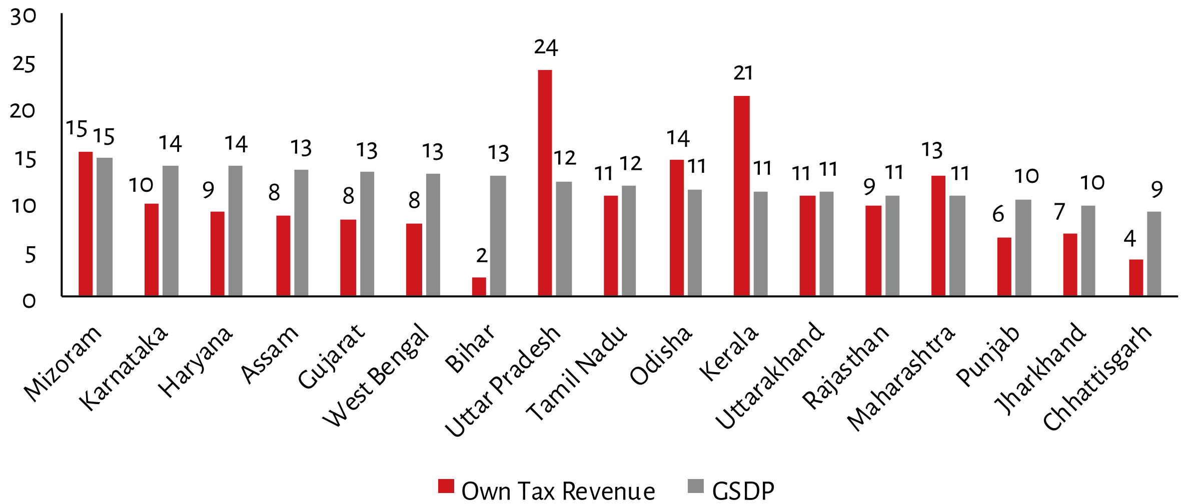
Given that these growth rates are likely to change due to restrictions from COVID-19, States such as Bihar, Chhattisgarh, and Punjab which had already anticipated lower growth rates in their own tax revenues (i.e. below 8 per cent) are likely to have a significant impact on their ability to meet expenditure needs. In contrast, States with a relatively higher anticipated growth rate include Kerala, Uttar Pradesh, Mizoram, and Odisha.

Growth Rate of Own Tax and Non-Tax Revenue in Comparison with GSDP

A comparison with GSDP growth rate indicates that four of the 17 States analysed - namely Uttar Pradesh (24 per cent), Kerala (21 per cent), Maharashtra (13 per cent), and Odisha (14 per cent) - expected a higher growth of own tax revenue in comparison with the growth rate of GSDP. Assuming that while the quantum may decrease but the trend continues, these States may have the potential to increase their tax-to-GSDP ratio, giving them relatively greater fiscal room.

> “States had anticipated a higher growth rate of own tax revenue at **12**% between FY 2019-20 RE and FY 2020-21 BE, compared to **5**% for non-tax revenue.”

Figure 7: Growth Rate of Own Tax Revenue in Comparison with GSDP for FY 2019-20 and FY 2020-21 BE

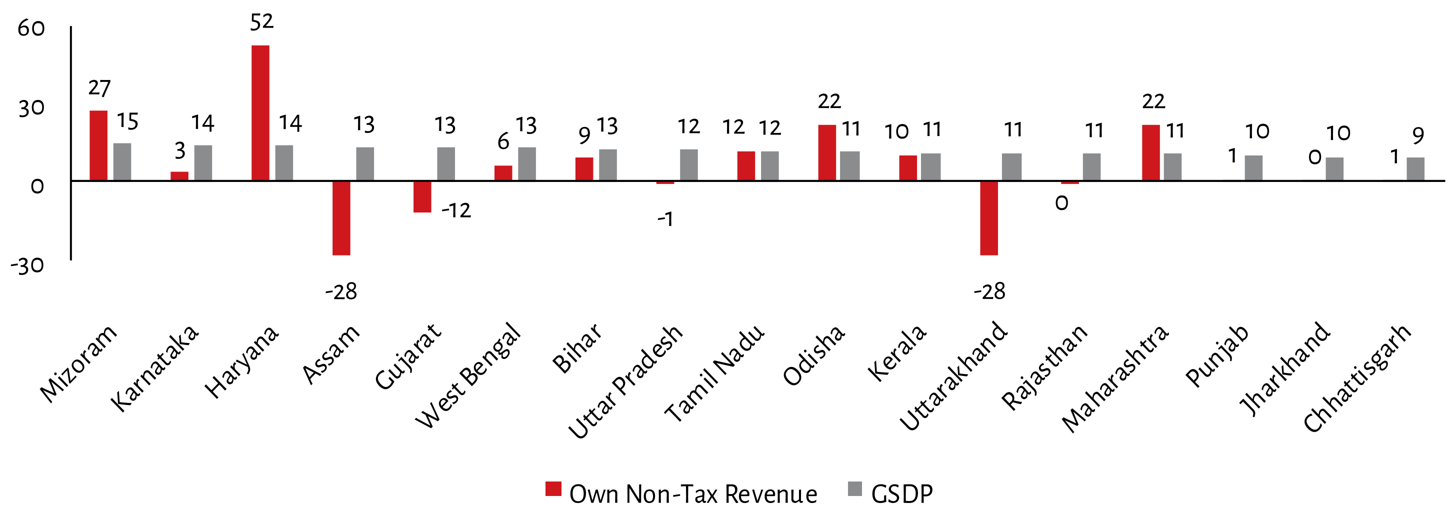


Source: *State Budget Documents*

With relatively less unpredictability in non-tax revenues, States which reported an expected higher growth rate in non-tax revenues include Haryana (52 per cent), Mizoram (27 per cent), and Odisha (22 per cent). In contrast, States such as Assam, Uttarakhand, Gujarat, and Uttar Pradesh reported negative growth rate, while Jharkhand and Rajasthan have reported no growth during the period between FY 2019-20 RE and FY 2020-21 BE.

In four States - namely, Haryana, Maharashtra, Mizoram, and Odisha - own non-tax revenue has grown at a higher rate in comparison to GSDP.

Figure 8: Growth Rate of Own Non-Tax Revenue in Comparison with GSDP for FY 2019-20 and FY 2020-21 BE



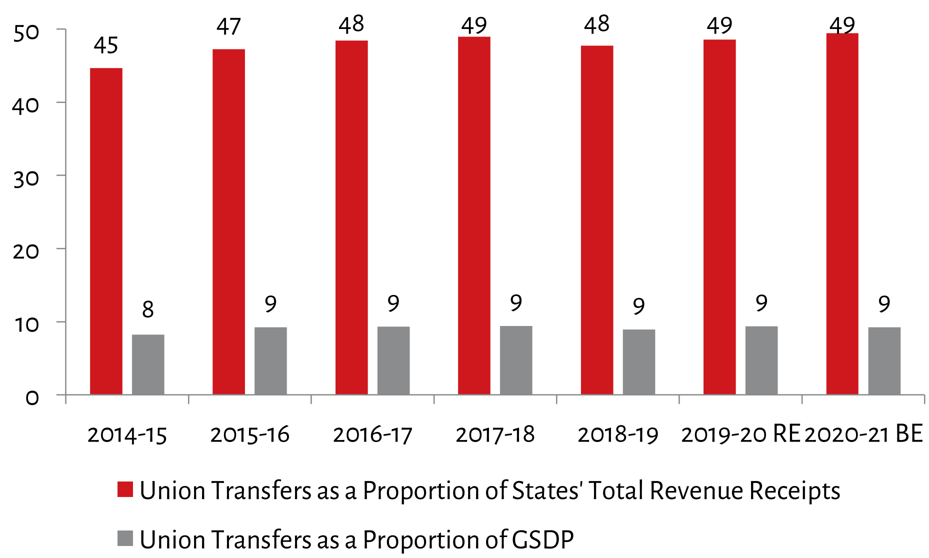
Source: *State Budget documents; GSDP figures from MoSPI.*

Union Transfers

Several States are highly dependent on the Union government for funds. Broadly, there are two main sources of funds from the Union government: a) States' share in Union taxes, and b) Grants-in-Aid, which include both Finance Commission grants and grants for Centrally Sponsored Schemes (CSSs).

The proportion of Union transfers out of total revenue receipts for the States has steadily increased over time, from 44.7 per cent in FY 2014-15 to 49.5 per cent in FY 2020-21 BE.

Figure 9: Union Transfers as a Proportion of States' Total Revenue Receipts and GSDP

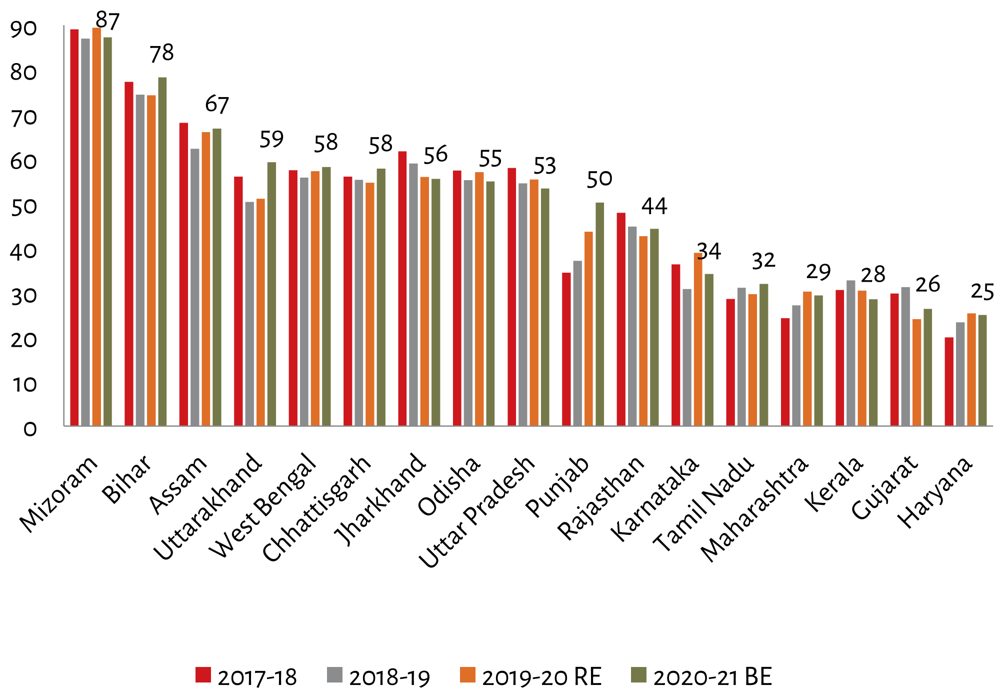


Source: *State Budget documents.*
Note: *GSDP in current prices.*

According to BEs for FY 2020-21, the proportion of funds received from the Union out of States' total revenue receipts is highest for Mizoram (87 per cent), Bihar (78 per cent) and Assam (67 per cent). States that are expected to receive a low proportion of funds from the Union include Haryana (25 per cent), Gujarat (26 per cent), Kerala (28 per cent), and Maharashtra (29 per cent).

> "The actual taxes devolved to states have remained consistently lower than those projected by the 14th FC. Part of the reason for this decline is the lower than expected GST revenue collections and greater imposition of cesses which remain outside the divisible pool."

Figure 10: Union Transfers to States out of their Total Revenue Receipts



Source: *State Budget documents.*

Tax Devolution

The 14th Finance Commission (14th FC), which came into effect in FY 2015-16, favoured more autonomy to States, compelling the Union government to provide a larger share of grants through tax devolution by increasing the share of the divisible pool of taxes to states from 32 per cent to 42 per cent. In its recommendations for the year FY 2020-21, the 15th Finance Commission (15th FC) proposed a marginal cut in the States' share in the divisible pool to 41 per cent, to create fiscal space for the newly formed Union Territories of Jammu and Kashmir, and Ladakh.

In terms of the quantum of funds, the 14th FC expected devolution to States to increase from ₹337,808 crore in FY 2014-15 to ₹579,282 crores in FY 2015-16. Subsequently, the FC had projected tax devolution to reach ₹1,034,745 crores by FY 2019-20 RE.[6] The 15th FC estimated that tax devolution to States for FY 2020-21 would stand at ₹855,176 crores.[7]

In our analysis of State budgets, we find that while the overall funds have increased, two important highlights emerge. First, despite the increase, the actual funds devolved to states have remained consistently lower than those projected by the 14th FC. As can be seen in the table below, during the 14th FC period, there was a difference of as much as ₹6.84 lakh crore between what was projected by the Commission and actual taxes devolved.

Part of the reason for this decline is the lower than expected GST revenue collections, discussed in detail in Section 4. In addition, this period has seen greater imposition of cesses which remain outside the divisible pool. As per RBI's report on State Finances, cesses and surcharges, which accounted for 2.3 per cent of gross tax revenue for the Union government in 1980-81, have risen to 15 per cent in recent periods.[8]

Table 1: Devolution of Taxes to States

Financial Year	Projected Tax Devolution to States (14^{th} FC)	Actual Tax Devolution	Difference: Actual Tax Devolution - Projected Tax Devolution as per 14^{th} FC
2015-16	579,282	506,193	-73,089
2016-17	668,425	608,000	-60,425
2017-18	772,304	673,005	-99,299
2018-19	893,430	761,454	-1,31,976
2019-20	1,034,745	714,889*	-3,19,856
Total (2015-20)	**3,948,187**	**3,263,541**	**-6,84,646**

Source: *14^{th} Finance Commission Report and Union Budget documents. Rupees in crores.*
Note: ** refers to Revised Estimates*

Consequently, on average, the proportion of share of Union taxes out of total revenue receipts was 21.4 per cent in FY 2014-15 which increased to 29.5 per cent in FY 2018-19. In the recent State budgets however, this proportion is estimated to decrease again to 25 per cent as per FY 2019-20 REs. For the 15^{th} FC period, the proportion remains the same at 25 per cent.

The second noteworthy factor is the change in the formula for tax devolution recommended by the 15^{th} FC. In addition to the reduction of 1 percentage point as discussed earlier, the 15^{th} FC changed the formula for the determination of inter-state share of taxes. One of the most contentious changes was the addition of a 10 per cent weight for the 2011 population, as opposed to the use of the 1971 populations by the previous FCs. To account for the "loss" to states who had undertaken population control, a new criterion called Demographic Control with a weight of 12.5 per cent was also introduced. Despite this change, the share in the divisible pool fell for a few States. Thus, while Uttar Pradesh and Bihar were expecting to receive the largest devolutions in FY 2020-21 BE, Karnataka and Kerala saw the largest decreases in the share of the divisible pool with a decrease of 0.49 per cent and 0.25 per cent, respectively (see Annexure 1 for more details).

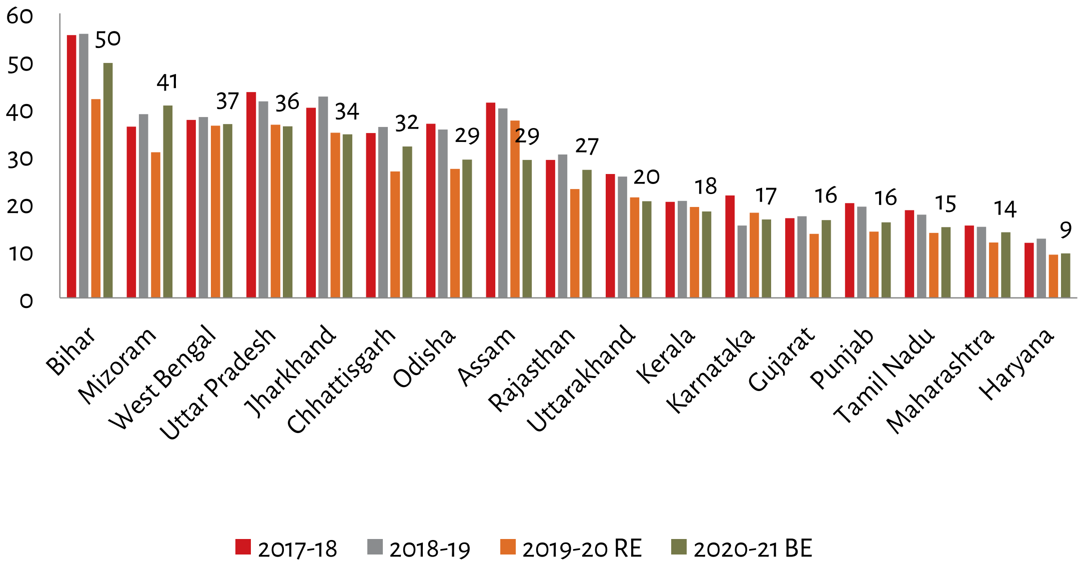
Table 2: Horizontal Devolution: Criteria and Weights across Finance Commissions

Criterion	13^{th} FC	14^{th} FC	15^{th} FC
Population (1971)	25%	17.5%	-
Population (2011)	-	10%	15%
Area	10%	15%	15%
Forest Cover	-	7.5%	-
Forest and Ecology	-	-	10%
Income Distance	-	50%	45%
Fiscal Capacity Distance	47.5%	-	-
Tax Effort	-	-	2.5%
Fiscal Discipline	17.5%	-	-
Demographic Performance	-	-	12.5%
Total	**100%**	**100%**	**100%**

Source: *13^{th}, 14^{th} and 15^{th} Finance Commission Reports.*

For the States analysed, in FY 2020-21 BE the share of Union taxes in total State receipts ranges from as high as 50 per cent in Bihar and 41 per cent in Mizoram to as low as 9 per cent in Haryana.

Figure 11: Share in Union Taxes received by States



Source: *State Budget documents.*

To conclude, although the share of Union transfers out of States' total revenue receipts has witnessed an increase over time, the gap in devolved taxes vis-à-vis the FC projections is noteworthy. Specifically for FY 2020-21, the 15th FC's estimations of the quantum of funds available for devolution were based on an expectation that tax buoyancy would improve to 1.14 in FY 2020-21 (around the average of FY 2011-12 to FY 2016-17 - six years prior to the introduction of the GST) and assuming a GDP growth of 11 per cent.[9] Both of these are unlikely given the current crisis.

The importance of tax devolution as a source of State finances lies in the fact that it is a source of relatively predictable, untied funds which allows States to determine their own expenditure priorities. In fact, the 14th Finance Commission was of the view that "*tax devolution should be the primary route of transfer of resources to States, since it is formula-based and, thus, conducive to sound fiscal federalism*".[9] The current COVID-19 crisis is likely to have a significant impact on the proportion of funds available to States through this route which, in turn, could place a fiscal burden on States, especially those that have greater dependence on Union transfers.

Grants-in-Aid from Union Government

Grants-in-Aid (GIA) have emerged as a substantial mode of spending for the Union Government for the provision of public goods. GIA from the Union is the amount of money disbursed by the Union Government to State governments under three components: (i) Grants as determined by the Finance Commission, (ii) Grants under CSSs, and (iii) Other transfers to meet operational expenses, generate capital assets and devote to delivery of public services. In this section, we discuss in brief the changes in the fiscal architecture of GIA from the Union, and State-wise trends in GIA received and its components. Given the significant differences at times between Actuals and REs and BEs for GIA, as far as possible, the analysis has been done separately for the time period 2014-18, and for FY 2019-20 RE and FY 2020-21 BE.

The GIA from the Union grew at around 12 per cent annually during the period FY 2015-16 to FY 2018-19, driven to a large degree by increases in CSSs and Other Transfers. CSS grew at a rate of 13 per cent, and Other transfers at a rate of 18 per cent. In contrast, GIA through FC grants increased by only 3 per cent, annually.

The trend differs a little for the remaining two years i.e. between FY 2019-20 RE and FY 2020-21 BE. Overall, GIA from the Union government to States was expected to grow at 16 per cent, annually, this time driven to a large degree by an expected compounded annual growth rate (CAGR) for FC grants at 21 per cent and a 27 per cent increase in Other transfers. In contrast, the expected increase in CSSs was lower at 7 per cent. These trends, however, are likely to change with the restructuring which will be undertaken owing to the relief measures announced for COVID-19 affected sectors.

Table 3: Grants-in-Aid from Union Government (₹ Crore)

Union Government Transfers	2015-16	2016-17	2017-18	2018-19	2019-20 RE	2020-21 BE	CAGR - 2015-16 to 2018-19	CAGR - 2019-20 to 2020-21
Centrally Sponsored Schemes	2,03,740	2,41,296	2,85,448	2,96,029	3,16,816	3,39,895	13%	7%
Finance Commission Transfers	84,579	95,550	92,244	93,704	1,23,710	1,49,925	3%	21%
Other Transfers	53,311	54,650	80,567	88,235	1,76,145	2,23,427	18%	27%
Total Transfers	3,41,630	3,91,496	4,58,259	4,77,967	6,16,670	7,13,246	12%	16%

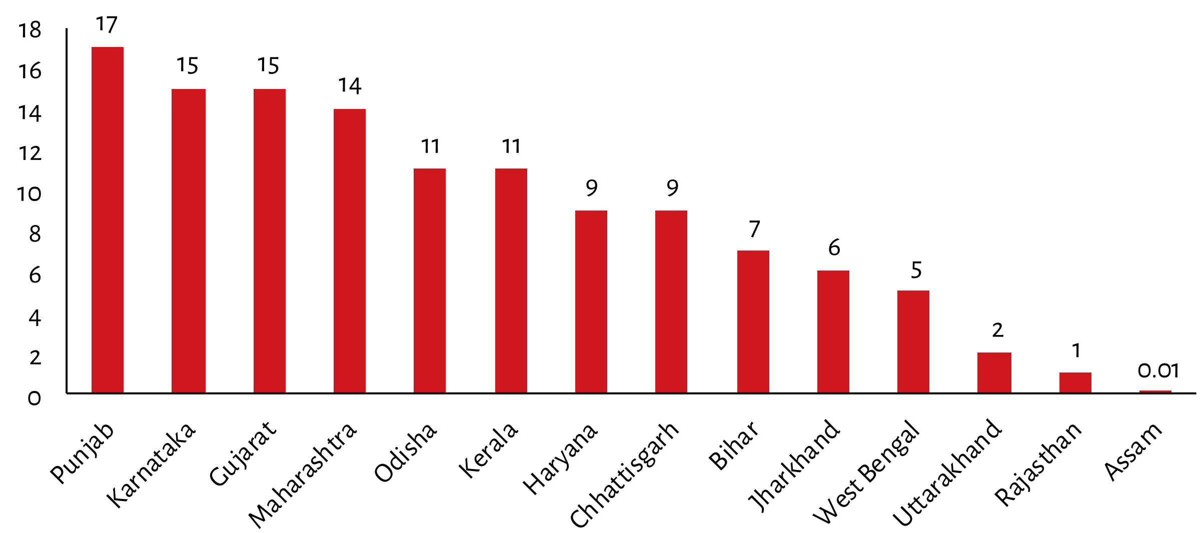
Source: *Union Expenditure Budget, Expenditure Budget, Summary of Expenditure FY 2015-16 to FY 2020-21. Available online at: https://www.indiabudget.gov.in. Last accessed on 1 May 2020.*
Note: *Figures are Actual Estimates (AEs), except for FY 2019-20 and FY 2020-21, which are Revised Estimates (REs) and Budget Estimates (BEs). Analysis has been restricted from FY 2015-16 as component-wise data was not available in FY 2014-15.*

“ Grants-in-Aid have emerged as a substantial mode of spending for the Union Government for the provision of public goods. GIA from the Union grew at around **12**% annually during the period FY 2015-16 to FY 2018-19, driven to a large degree by increases in CSSs and Other Transfers. ”

State-wise Trends in Receipts of GIA

The graph below shows the average annualised growth rate of revenue receipts incurred through GIA in the years between FY 2014-15 and FY 2018-19 for the States analysed. Among the 17 States, Punjab has shown the highest annual rate of growth at 17 per cent. It was closely followed by Gujarat and Karnataka at 15 per cent. Rajasthan and Assam on the other hand, recorded one of the lowest annual growth in GIA at 1 per cent and at .01 per cent, respectively.

Figure 12: Average Annualised Growth in GIA - FY 2014-15 to FY 2018-19



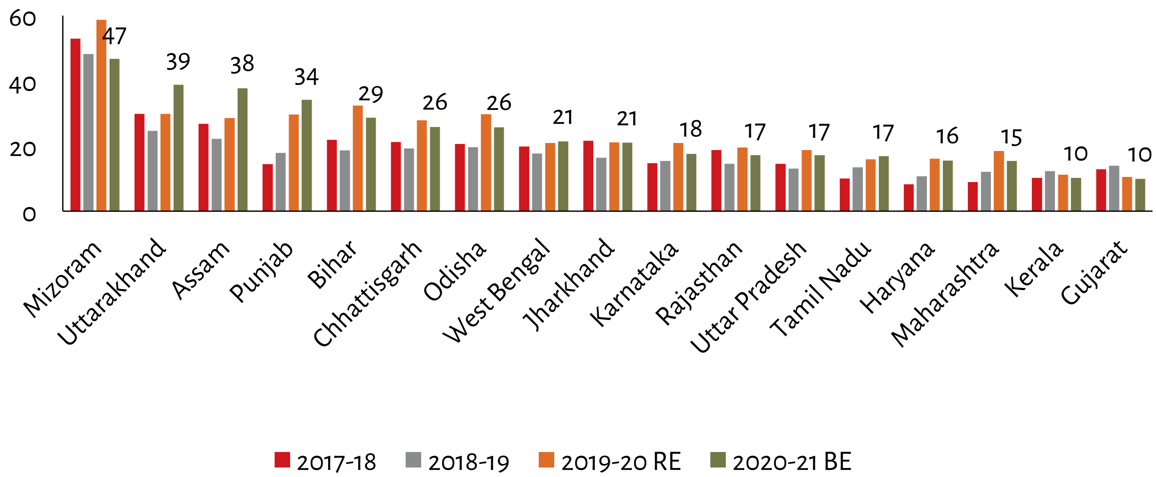
Source: *State Budget documents.*

GIA share out of Total Revenue Receipts

It is important to note that the share of GIA out of total revenue receipts has been decreasing for most of the States, driven partly by the acceptance of the recommendations of the 14th FC. A State-wise trend, however, shows that the decrease in share during FY 2017-18 and FY 2018-19 was highest for fiscally weaker States such as for Mizoram, Uttarakhand, Assam, Bihar, Chhattisgarh, Odisha, West Bengal, Jharkhand, Rajasthan, and Uttar Pradesh.

In contrast, the proportions increased for States like Punjab, Karnataka, Tamil Nadu, Maharashtra, Kerala, and Gujarat. Part of this could be due to lower expenditure capacity which impacts receipts and expenditures particularly for CSSs, discussed in detail in the next section. For FY 2020-21 BE, the situation is different. The States that were to receive a high proportion of GIA out of total revenue receipts are Mizoram (47 per cent), Uttarakhand (39 per cent), Assam (38 per cent), Punjab (34 per cent), and Bihar (29 per cent). On the other hand, GIA from the Union government forms a lower share of revenue receipts in Gujarat (10 per cent), Kerala (10 per cent), and Maharashtra (15 per cent).

Figure 13: Grants-in-Aid received by States out of Total Revenue Receipts



Source: *State Budget documents.*

This difference in trend could be the result of significant differences in the amounts budgeted by the Union government with respect to GIA and the actual funds released and utilised by States. As can be seen in Table 4, while Actuals remained significantly higher than BEs in FY 2016-17 and FY 2017-18, the trend appears to have reversed in FY 2018-19 with Actuals being ₹68,896 crore less than those budgeted.

Table 4: Budget Estimates and Actual Expenditure of GIA transfers (in ₹ Crore)

Figure	2016-17	2017-18	2018-19	2019-20
Grants-in-Aid from GOI (Budget Estimates)	377,019	423,328	546,863	597,130
Grants-in-Aid from GOI (Actuals)	391,496	458,259	477,967	*616,670
Difference	-14,477	-34,931	68,896	-19,540

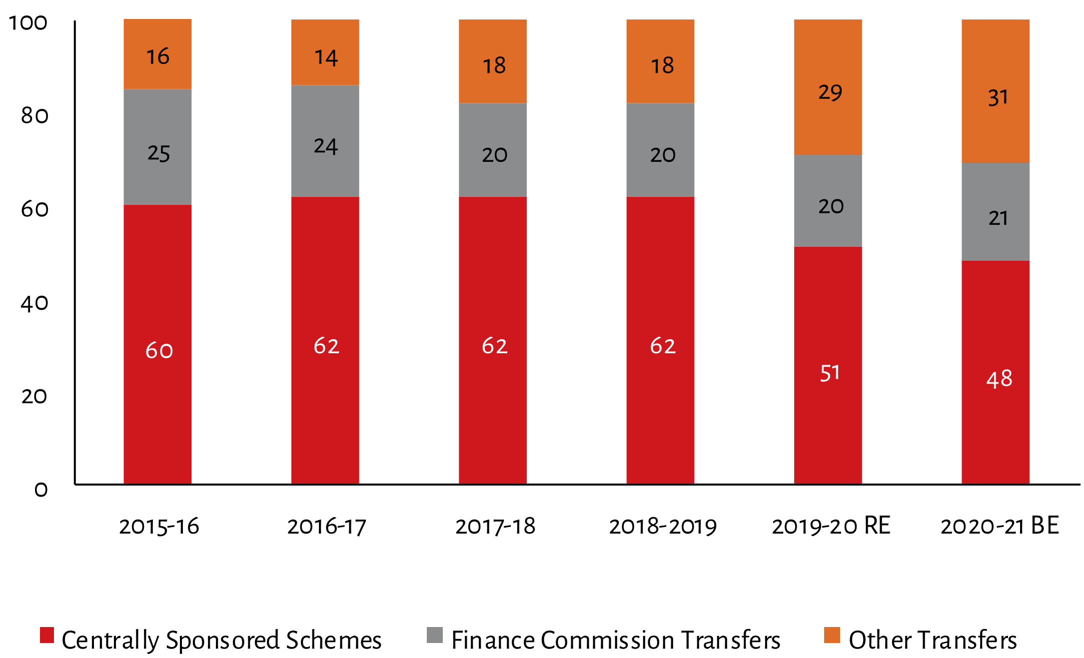
Source: *Union Expenditure Budget, Expenditure Budget Profile, Summary of Expenditure FY 2016-17 to FY 2019-20. Available online at: https://www.indiabudget.gov.in. Last accessed on 1 May 2020.*
Note: ** are Revised Estimates (REs) .*

What drives this unpredictability? The next section will look a little deeper into the different constituents of GIA.

Composition of GIA

A breakdown of the different components of GIA finds that CSSs constitute the largest share of GIA transfers between FY 2015-16 and FY 2020-21 BE. Till FY 2018-19, the share has remained constant at 62 per cent, but declined to 51 per cent in FY 2019-20 RE and further to 48 per cent in FY 2020-21 BE. The ratio of FC grants to total GIA also decreased from 25 per cent in FY 2015-16 to 21 per cent during FY 2020-21 BE. On the other hand, in the same period, the proportion of Other transfers nearly doubled (mainly due to the introduction of GST compensation) from 16 per cent in FY 2015-16 to 31 per cent during FY 2020-21.

Figure 14: Share of Grants-in-Aid Components



Source: *Union Expenditure Budget, Expenditure Budget, Summary of Expenditure FY 2015-16 to FY 2020-21. Available online at: https://www.indiabudget.gov.in. Last accessed on 1 May 2020.*
Note: *Figures are Actual Estimates (AEs), except for FY 2019-20 and FY 2020-21, which are Revised Estimates (REs) and Budget Estimates (BEs).*

Here too, however, it is important to note that there are differences between the figures initially budgeted for and Actuals. As can be seen in the Table below, while Actuals for CSSs remained higher than BEs between FY 2016-17 and FY 2017-18 (due partly to the adjustments following the acceptance of the 14th FC recommendations), in FY 2018-19, they were lower by ₹9,488 crores. Similarly, revised estimates for FY 2019-20 were lower than the BEs by ₹14,794 crores.

For FC grants, Actuals have remained consistently lower than BEs across the years. In contrast, while the difference in BEs and Actuals was most acute for Other transfers, for all years except FY 2018-19, Actuals have been higher than amounts originally budgeted.

Table 5: Budget Estimates and Actual Expenditure of GIA Components (in ₹ Crore)

GIA Components	2016-17	2017-18	2018-19	2019-20
CSS from GOI (Budget Estimates)	2,31,900	2,78,433	3,05,517	3,31,610
CSS from GOI (Actuals)	2,41,296	2,85,448	2,96,029	3,16,816*
Difference	**-9,396**	**-7,015**	**9,488**	**14,794**
Finance Commissions Grants (Budget Estimates)	1,00,646	1,03,101	1,09,374	120466
Finance Commissions Grants (Actuals)	95,550	92,244	93,704	1,23,710*
Difference	**5,096**	**10,857**	**15,670**	**-3244**
Other Transfers (Budget Estimates)	44,473	41,793	1,31,973	1,45,054
Other Transfers (Actuals)	54,650	80,567	88,235	1,76,145*
Difference	**-10,177**	**-38,773**	**43,738**	**-31,090**

Source: *Union Expenditure Budget, Expenditure Budget Profile, Summary of Expenditure FY 2016-17 to FY 2019-20. Available online at: https://www.indiabudget.gov.in. Last accessed on 1 May 2020.*
Note: ** are Revised Estimates (REs)*

Finance Commission Grants

A Finance Commission (FC) is a constitutionally mandated body set up every five years under Article 280 of the Constitution by the President of India. Its main mandate is to evaluate the finances of the Union government and States, and make recommendations to remedy the horizontal fiscal imbalance[10] through the distribution of tax revenues between Union and State governments, and further among the States. In addition to tax devolution, the FC also provides GIA to augment the Consolidated Fund of a State including ways to supplement the resources of Panchayati Raj Institutions (PRI), such as Rural Local Bodies (RLBs), and Urban Local Bodies (ULB). Moreover, Article 275 of the Constitution enables the FC to give grants to offset gaps between normatively assessed revenues and expenditures. Before the removal of the Plan and Non-Plan distinction, FC Grants (FCGs) were a part of Non-Plan grants.

The nature of GIA has varied significantly across FCs. While all three FCs covered in this analysis have recommended grants for local bodies, the 13th FC focussed significantly on sector-specific grants aimed at reducing inequalities in the standards of various administrative and social services across States and provided resources for specific activities considered to be national priorities. As a proportion of total GIA, these sector-specific grants constituted 19 per cent and State-specific grants for State-specific needs accounted for 9 per cent. In addition, the 13th FC made specific GIA as performance incentive grants and a grant of ₹50,000 crore for the implementation of GST (see Table 6 for more details).

The 14th FC, on the other hand, held that State-specific schemes are best prioritised and financed at the level of the State government. Keeping in mind the repeatedly raised issue by State governments on the need for flexibility, it did not provide any GIA through either State-specific grants or sector-specific grants, which often required the provision of utilisation certificates and came with other conditionalities for release. Instead, it increased the share of funds received through tax devolution (which are untied in nature) and provided additional GIA to augment the resources of RLBs and ULBs to ₹2.87 lakh crore from the previous ₹85,519 crores.

As per the recommendations of the 15th FC interim report for FY 2020-21, the Commission refrained from providing any State-specific grants, as was the case with the 14th FC. However, the 15th FC provided a roadmap for performance-based incentives and sector-specific grants (in addition to the ₹7,375 crores already provided for nutrition this fiscal year), that they expect to address in greater detail in the final report.

The Terms of Reference of each FC and their recommendations has an impact on the quantum of funds provided as GIA by respective FCs. For instance, GIA to States increased from ₹318,581 crore in the 13th FC award period to ₹537,354 crores in 14th FC award period. The 15th FC estimates ₹193,899 crores as FCGs to States for FY 2020-21.

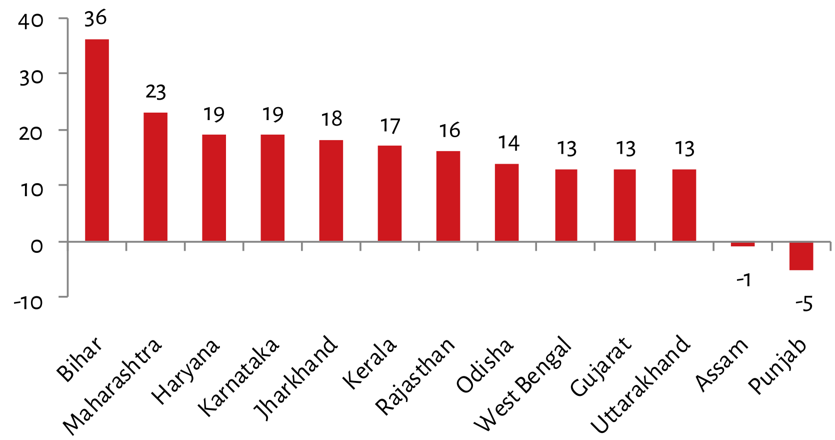
Table 6: Grants-in-Aid to States, as per Recommendation of 13th ,14th and 15th Finance Commission (in ₹ Crore)

Components of GIA as per Finance Commission	13th FC- 2010-15	14th FC- 2015-20	15th FC 2020-21
Local Government	87,519	2,87,436	90,000
Disaster Management	26,373	55,097	22,184
Post-devolution Revenue Deficit	51,800	1,94,821	74,340
Performance Incentive	1,500	-	-
Improving Outcomes	14,446	-	-
Sector Specific Grants	58,998	-	7,375
State-Specific Grants	27,945	-	-
Implementation of model GST	50,000	-	-
Special grants	-	-	6,764
GIA to States	**318,581**	**537,354**	**193,899**

Source: *Calculation of Grants-in-Aid Components, based on data accessed from 13th, 14th and 15th Finance Commission Report. Available online at: https://fincomindia.nic.in/. Last accessed on 8 May 2020.*

A State-wise analysis shows that these changes have had an impact on the receipts of FCGs to States. Of the 13 States analysed,[11] the average annualised growth rate of FCGs was highest for Bihar at 36 per cent - 5 times higher than rate of growth in total GIA during the same period. On the contrary, in both Assam and Punjab there was a decline in FCGs transferred over these four years - while grants in Assam declined by 1 per cent, in Punjab they declined by 5 per cent.

Figure 15: Average Annualised Growth Rate of Finance Commission Grants - FY 2014-15 to FY 2018-19

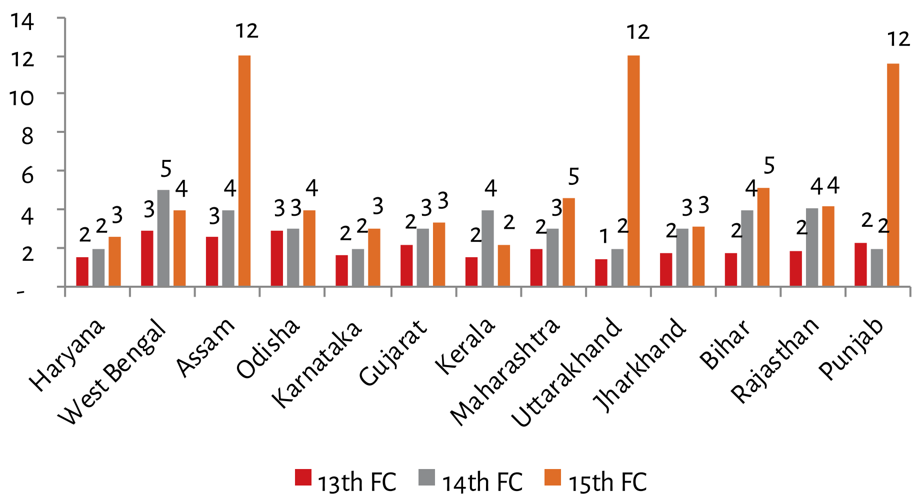


Source: *State Budget documents.*

In FY 2020-21 BE, the changes in the total quantum of FCGs and the quantum of revenue receipts expected has an impact on the share of FCGs in States total revenue receipts. Between the 13th and 14th FC period, the share of FCGs in total revenue receipts increased by 2 percentage points in West Bengal, Kerala, Bihar, and Rajasthan. In contrast, these shares remained relatively similar in Haryana, Odisha, Karnataka and Punjab.

For the first year of 15th FC period i.e. FY 2020-21 BE, the share of FCGs in the States' total revenue receipts ranged from 2 per cent in Kerala to 12 per cent in Assam, Uttarakhand and Punjab. However, it is important to note that while these ratios are higher than previous years, given that Actuals for FC grants have typically remained lower than BEs for previous years, they are likely to change by the time actual estimates will be released.

Figure 16: Proportion of FC grants out of Total Revenue Receipts



Source: *State Budget documents.*

Note: *13 FC include 2014-15 Actual Estimates, 14 FC include average of 2015-16 to 2019-20 and 15 FC include 2020-21 Budget Estimates.*

Centrally Sponsored Schemes

Centrally Sponsored Schemes (CSSs), also referred to as specific purpose transfers, are one of the primary instruments through which the Union government directs social policy financing with an aim to ensure that minimum standards of public services are provided to all citizens. Specifically, for States, their relative importance lies in the fact that they are the primary source of non-wage funds available to States.

Over time, the dominance of CSSs has been evident in the sheer number of schemes and quantum of funds flowing through CSSs, including in areas under the States' mandate. For instance, of the total ₹8.61 lakh crore transferred by the Union government to States between 2012 and 2015, ₹5.88 lakh crore (68 per cent) was released as assistance under CSSs.[12]

Yet they have often been at the centre of debate with respect to fiscal federalism due to their design and implementation challenges.[13] Typically, CSSs are designed by the Union government with fixed norms and rigid guidelines prescribed to States, resulting in a 'one-size-fits-all' approach. The planning process embedded in most CSSs too favours centralisation, with the Union government responsible for approving all State plans, thereby allowing it to exercise significant control. These factors have resulted in reducing the States' flexibility to spend as per their needs.

Fiscally, funding for CSSs are shared between the Union government and States, with States expected to contribute anywhere between 10 per cent to 50 per cent of the total allocations, out of their own resources. Moreover, the release of funds are not based on a particular formula (as with tax devolution and FC grants), but instead on meeting certain conditionalities. This has resulted often in an inequitable distribution of CSS funds. Analysis by the Economic Survey 2016-17, had found that of the top six CSSs - Pradhan Mantri Awas Yojana (PMAY), Sarva Shiksha Abhiyan (SSA), Mid-Day Meal (MDM), Pradhan Mantri Gram Sadak Yojana (PMGSY), Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) and Swachh Bharat Mission (SBM) - in no scheme did the poorest districts receive even 40 per cent of the total resources.[14]

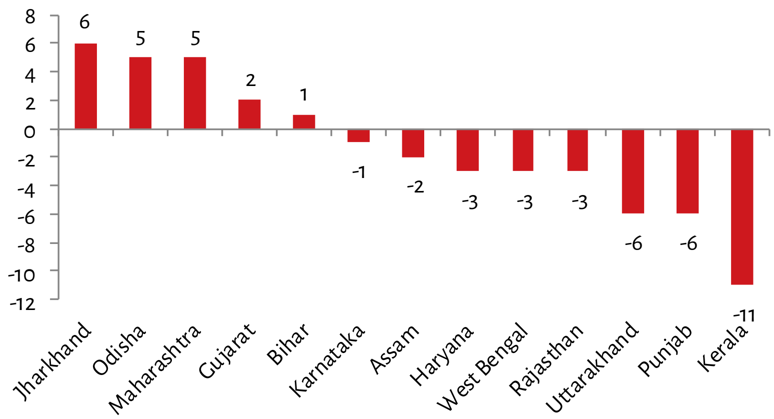
It was in recognition of these very challenges that led the 14th FC to increase the share of untied funds transferred to States, whilst calling for a reduction in the CSS mode. As the 14th FC noted, "*We recognise that some of the current Centrally Sponsored Schemes relate to subjects that can best be handled entirely by the States and, hence, should be in the fiscal space of States alone.*"[15]

The acceptance of the recommendations of the 14th FC was followed by the constitution of a sub-group of Chief Ministers on restructuring CSSs which made key recommendations including scheme rationalisation, need for a transparent criterion for allocation, increasing flexibility to States by earmarking 25 per cent as flexi-fund, and allowing States to choose their priority areas within a CSS or across CSSs.

Immediately following the acceptance of the recommendations of the 14th FC and consequent increase in tax devolution to States, the Union government decreased the quantum of funds going through CSSs. As can be seen in the graph below, the average annualised growth rate of GIA through CSS between FY 2014-15 (the last year of the 13th FC period) and FY 2018-19 (in the 14th FC period) declined for most States. The decrease was most significant for Haryana, West Bengal, Assam, Karnataka, Kerala, Uttarakhand, Rajasthan, and Punjab. On the other hand, States such as Jharkhand and Odisha saw an increase of 6 per cent and 5 per cent, respectively.

> CSSs constitute the largest share of GIA transfers. Till FY 2018-19, the share has remained constant at 62 per cent, but declined to 51 per cent in FY 2019-20 RE and further to 48 per cent in FY 2020-21 BE.

Figure 17: Average Annualised Growth Rate in GIA through CSSs - FY 2014-15 to FY 2018-19



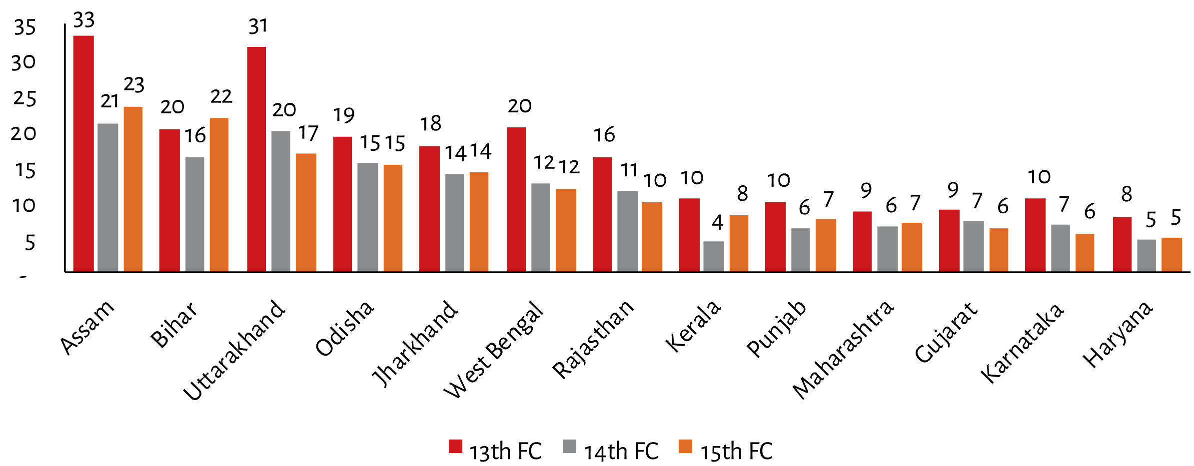
Source: *State Budget documents.*

It is important, however, to highlight, as previously mentioned, that the decrease in Union GIA to States in the form of CSSs, was accompanied by an increase in States' share of CSS budgets. For some States, this resulted in an increase from 25 per cent as State share to as high as 40 or 50 per cent. This, thus, has an impact on the States' flexibility by eroding into its untied funds which are then funnelled back into CSSs. Analysis undertaken by Amarnath and Singh (2018) found that in FY 2015-16 for General Category States, the average burden due to CSSs amounted to 0.69 per cent of GSDP compared to the average gain for tax devolution at 0.71 per cent of GSDP. In FY 2016-17, the figures are 0.68 per cent and 0.69 per cent of GSDP, respectively.[16]

While the overall quantum of funds through CSS has declined for many States, they still constitute a significant portion of States' revenue. As can be seen in the graph below, in some States such as Assam, Bihar, and Uttarakhand, they constitute nearly 20 per cent of total revenue receipts of the State. For FY 2020-21 BE, the share of GIA through CSSs was, in fact, expected to increase in a number of States. These proportions mask the relevance of financing through CSSs for a number of sectors and schemes. Forthcoming analysis by the Accountability Initiative, Centre for Policy Research found that in the case of Elementary Education, the proportion of funds routed to the sector through CSSs could be as high as 65 per cent in States such as Bihar.[17]

“The decrease in Union GIA to States in the form of CSSs, was accompanied by an increase in States' share of CSS budgets. For some States, this resulted in an increase from 25% as State share to as high as 40% or 50%.”

Figure 18: Proportion of CSS Grants out of Total Revenue Receipts



Source: *State Budget documents.*

Note: *13th FC include 2014-15 Actual Estimates, 14th FC include average of 2015-16 to 2019-20, and 15th FC include 2020-21 Budget Estimates.*

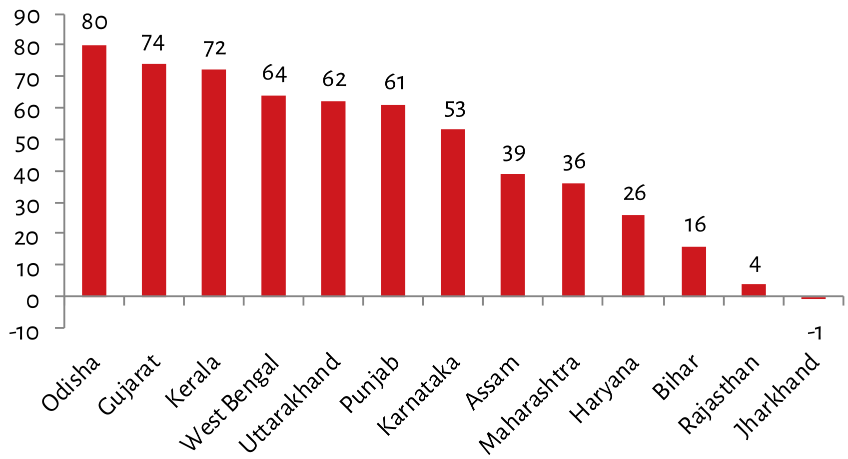
The analysis of CSSs has two immediate implications from the perspective of the current COVID-19 crisis. First, despite a decline in GIA through CSS, recent years have seen an increase in both the number of schemes as well as the quantum of funds flowing through CSSs. With States expected to provide their own shares and the centralised design of CSSs, this could have an impact on the ability of States to respond effectively to the current crisis by constraining their ability to direct funds as per their needs. Moreover, the recent directive by MoF calling for expenditure ceilings in certain Ministries could further lead to unpredictability in receipts.

Other Grants and Transfers

Other grants and transfers to States include all other transfers made under National Disaster Response Fund (NDRF), assistance to schemes under proviso(i) to Article 275(1) of the Constitution, and compensation for loss of revenue arising out of implementation of GST and compensation of Union levied Central Sales Tax.

With the introduction of GST, these GIA have seen a significant increase. For States, the annual rate of change for Other transfers and grants varied from -1 per cent in Jharkhand to as high as 80 per cent in Odisha. The high growth rate in Odisha was seen due to increase in grants for compensation for loss of revenue arising from GST implementation. More details, including recent and expected trends specifically on the GST component will be discussed in further sections.

Figure 19: Average Annualised Growth Rate for Other Grants and Transfers - FY 2014-15 to FY 2018-19



Source: *State Budget documents.*

Disaster Response Funds

The State Disaster Response Fund (SDRF) serves as the principal source of funding for State governments to redress notified disasters and offer immediate relief to victims. The Union government contributes 75 per cent for the provision of SDRF for General Category States and 90 per cent for North-Eastern and Hilly States. The National Disaster Response Fund (NDRF) is meant as an augmentation in case of severe disasters when the funds available in the SDRFs are inadequate. Our analysis considers SDRF and NDRF transfers together as Disaster Response Funds.

The 15th FC recommended the creation of funds for disaster mitigation along with disaster response, which will now together be called as National Disaster Risk Management Fund (NDRMF) and State Disaster Risk Management Funds (SDRMF). It also recommended an increase in the share of SDRF and NDRF to 80 per cent, and the share of State Disaster Management Funds (SDMF) and the National Disaster Management Fund (NDMF) at 20 per cent. As per the recommendation of 15th FC, the total amount allocated to the States for SDRMF is ₹28,983 crore in FY 2020-21 BE. Out of this, the Union share is ₹22,184 crore, which is 114 per cent more than the ₹10,344 crore provided for SDRF in the FY 2019-20 BEs.[18] The final SDRMF allocation for each State has been computed based on the following factors: the expenditures incurred by States on disaster management (with a weightage of 70 per cent), population (15 per cent weightage), area (15 per cent weightage), and risk profile of individual States, calculated on the basis of the Disaster Risk Index, which is developed by assigning scores to the possibility of events like cyclone, drought and flood, and the degree of their vulnerability.

Area, population and risk profile are new indicators that are being considered for calculation of State allocations by the 15th FC. NDRMF allocation to States is determined by using an expenditure-based methodology. The average of inflation-adjusted expenditure of the previous five years (Actuals from FY 2015-16 to FY 2017-18, and BEs from FY 2018-19 and FY 2019-20) is then increased by 10 per cent to arrive at this allocation.[18]

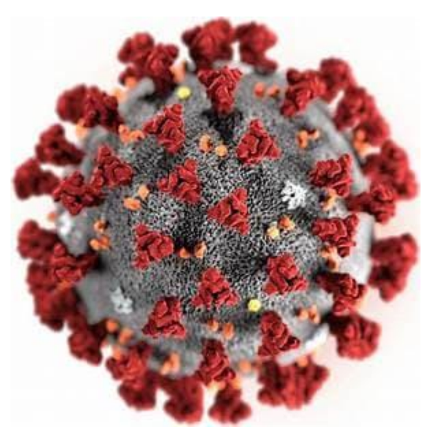


Table 7: Disaster Risk Management Funds for FY 2020-21

National Corpus	FY 2020-21 (In ₹Crores)	States' Corpus	FY 2020-21 (In ₹Crores)
NDMF	2,478	SDMF	5,797
NDRF	9,912	SDRF	23,186
Total NDRMF	**12,390**	**Total SDRMF**	**28,983**

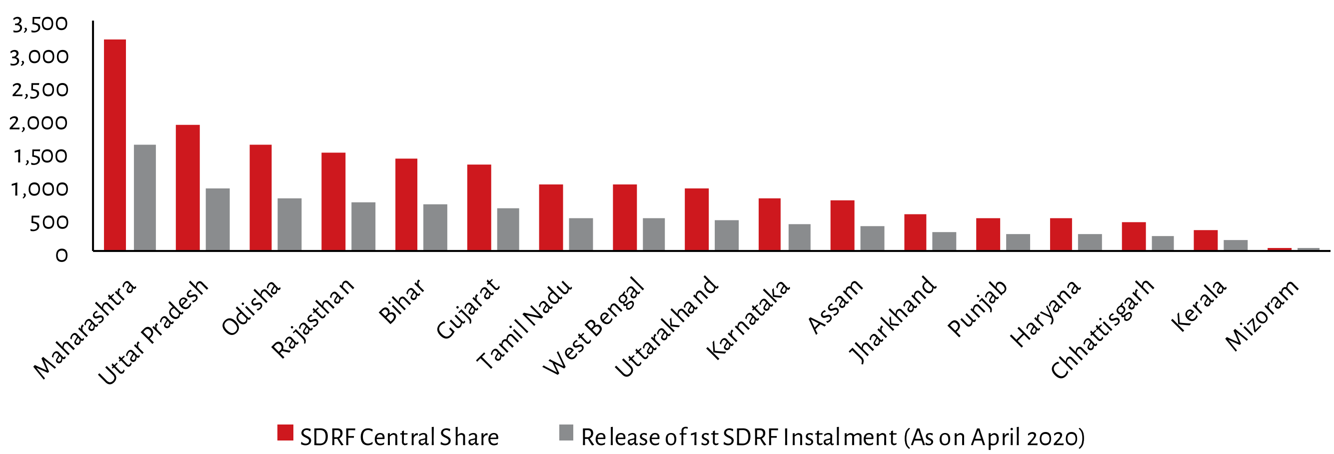
Source: *15th Finance Commission Report. Available online at: https://fincomindia.nic.in/. Last accessed on 8 May 2020.*

For most of the States, the contribution of Disaster Response Funds out of total GIA transfers remained below 10 per cent between FY 2017-18 and FY 2020-21 BE, with the exception of Kerala at 27 per cent in FY 2018-19 owing to the floods in the State.

However, with India declaring the COVID-19 pandemic as a notified disaster in March 2020, thereby allowing States to mobilise funds for providing aid in response,[19] the share of these GIA are likely to increase.

The first instalment of the Union's share of SDRMFs which is 50 per cent of its total allocation was released in April 2020, in response to the COVID-19 outbreak. As per the current guidelines,[20] the SDRMF fund can be used for provision of cluster containment, quarantine, sample collection, screenings and purchase of personal protective equipment for health, municipal, police and fire authorities. The graph below presents the State-wise allocations and release of Union government's share of the SRDMF as of April 2020.

Figure 20: Allocation and Release of funds under SDRMF - FY 2020-21



Source: *Disaster Management Division, Ministry of Home Affair.*

KEY TAKEAWAYS

- The ability of a State to respond to the COVID-19 pandemic may be impacted by the source of their revenues.
- The shortfall in tax devolution due to declines in revenue collected and unpredictability in GIA especially CSSs can hamper state planning.
- With States being at the frontlines of the current COVID-19 crisis and having significant expenditure responsibilities, it is critical that they have the necessary revenues to meet their expenditure needs.

SECTION 4

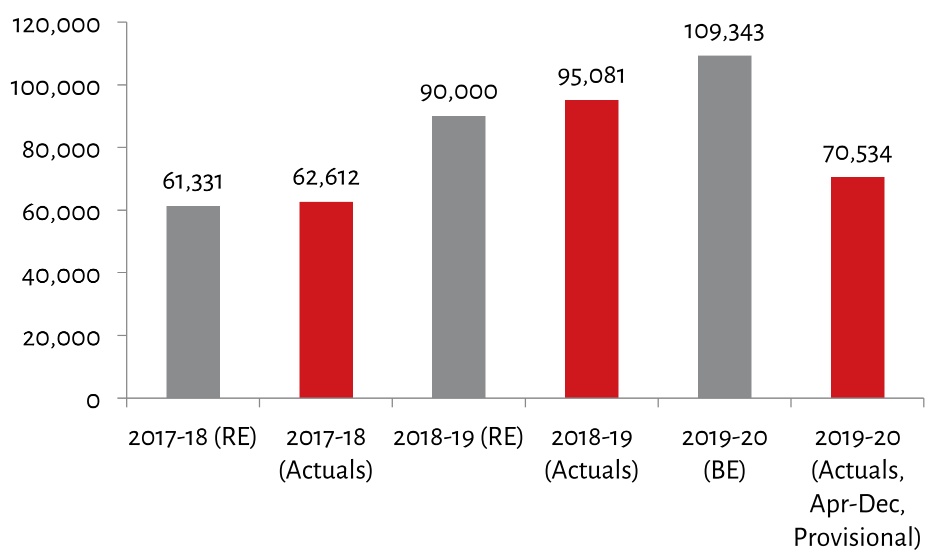
4. RECENT POLICY ADVANCES

GST Compensation

With the roll-out of GST and institution of the GST Council, the Union government will recompense States for a loss in revenue from the change in taxation systems for the first five years. SGST revenues are assumed to grow at a pace of 14 per cent per annum, with FY 2015-16 as the base year. The difference between the estimated level and actual SGST earned is provisioned to the States as GST compensation. This, therefore, forms an alternative source of revenue for States.

Between FY 2017-18 and FY 2018-19, GST compensation paid out by the Union government saw a 52 per cent jump from ₹62,612 crore to ₹95,081 crore. The RE for FY 2019-20 is estimated at ₹1.09 lakh crore, a 15 per cent increase over the actual expenditure from the previous year.

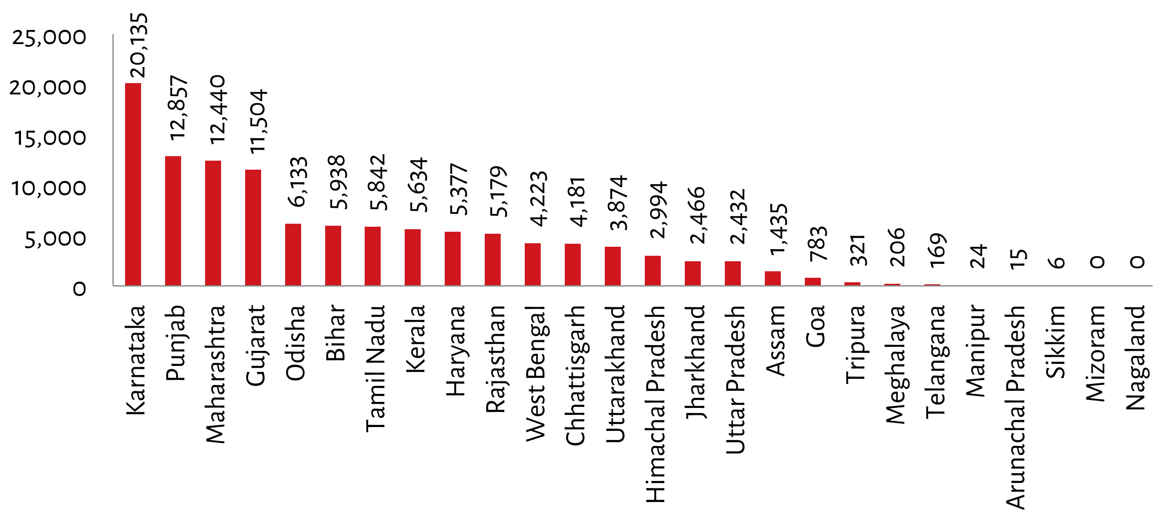
Figure 21: GST Compensation Cess



Source: *Lok Sabha Questions.*

Combined over the period's FY 2017-18 and FY 2018-19, GST compensation receipts were highest for Karnataka, Punjab, Maharashtra and Gujarat. These were the lowest in the North Eastern States, Andhra Pradesh and Goa.

Figure 22: GST Compensation received by States – 2017-19

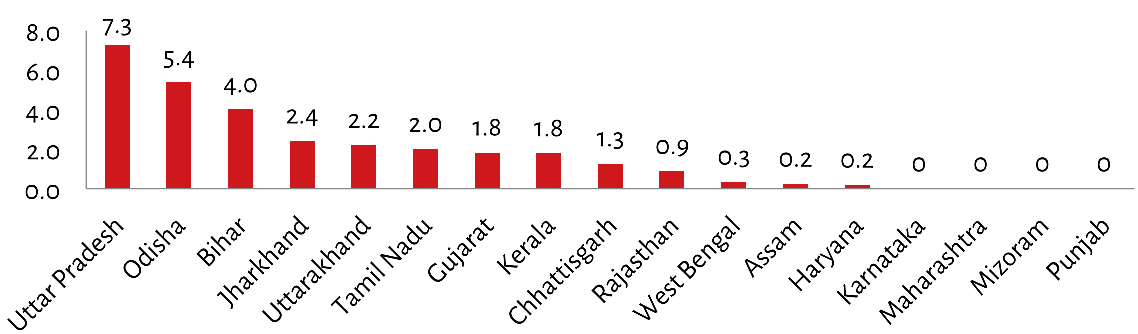


Source: *Press Information Bureau.*

Several factors impose constraints on the receipts of revenue through GST compensation by the States. The past periods have seen a divergence between the amount of GST compensation owed and the actual payout to States, including for States that need greater fiscal support from the Union government (such as Odisha, Bihar, Jharkhand, Uttarakhand, and Chhattisgarh). Declining rates of growth of States' total revenues implies that higher amounts would be owed as GST compensation. This factor, coupled with a recent fall in the Union's gross GST and GST compensation cess collection, has resulted in incomplete and delayed transfers to the States. This further restricts the fiscal room available to States to undertake expenditures.

A comparison between the SGST owed or budgeted and the actual SGST given for FY 2018-19 shows that the shortfall was the highest in Uttar Pradesh (7 per cent), Odisha (5 per cent) and Bihar (4 per cent). States which did not witness a shortfall in SGST included Maharashtra and Punjab. Further, in Karnataka and Mizoram, SGST collection was higher than the projected tax revenue and, consequently, no compensation payment was needed.

Figure 23: Shortfall in GST Compensation - FY 2018-19



Source: *Mukherjee (2020), AI Analysis.*

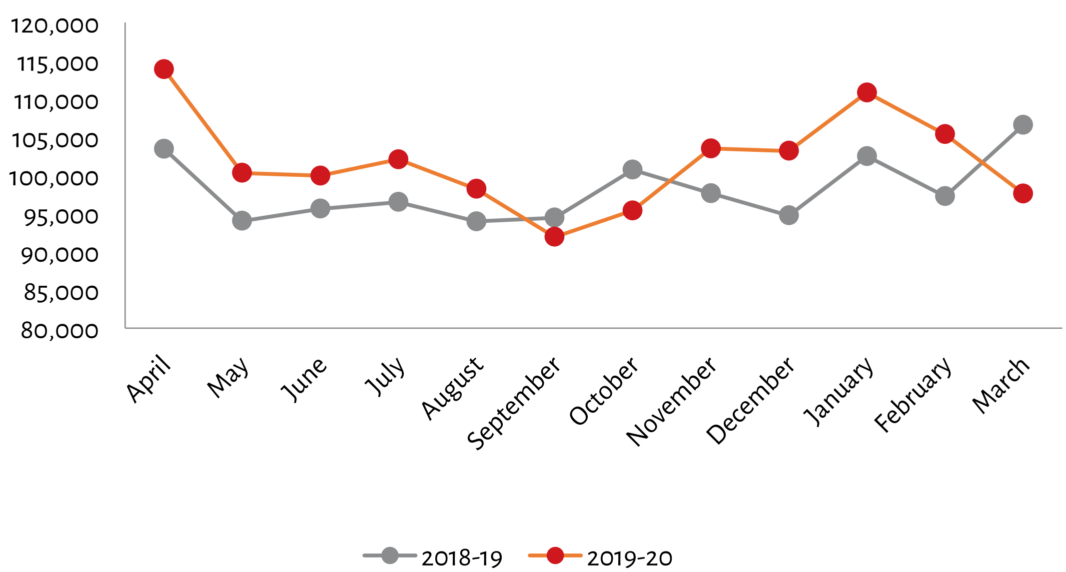
Two fiscal factors are exerting pressure on the payment of GST compensation from the Union to the States – a slowdown in States' revenue receipts and decline in Union governments gross GST collection.

For the previous five-year period from 2015-20, the average annual growth rate in revenue receipts was 13.5 per cent in the 17 States under consideration. However, between FY 2018-19 and FY 2019-20 RE, even before the COVID-19 crisis, 11 States – including Gujarat, Maharashtra, Odisha, Rajasthan and Uttar Pradesh – estimated a revenue growth rate below the estimated level of 14 per cent. This revenue shortfall implies that the Union government would be required to pay out greater sums as GST compensation.

At the same time, design and implementation hurdles in the roll-out of GST has led to lower than expected GST revenues for most years. For FY 2017-18, the CAG estimated a 10 per cent decline in the Union government's revenue on goods and services compared to revenues of subsumed taxes in FY 2016-17.[20] For FY 2018-19, actual collection stood 22 per cent lower than that estimated. The current crisis is likely to lead to a further reduction in GST revenues, thereby widening the gap between revenue and expenditure.[22]

In FY 2019-20, the month-on-month growth in gross GST collection saw a negative rate in seven months. Overall GST revenue has been on a downward trajectory in 2020, with March 2020 collections being 14.3 per cent lower than those seen at the start of the fiscal year in April 2019. Further, the Union government anticipates a shortfall in GST compensation cess to the tune of ₹63,200 crore in FY 2019-20. The estimated cess requirement for FY 2019-20 was ₹1.6 lakh crores and the expected collection is ₹96,800 crore.[23]

Figure 24: Gross GST Collection – FY 2018-19 and FY 2019-20



Source: *Press Information Bureau.*

The decline in GST collection and the increasing gap between GST compensation requirement and the pay-out of the compensation has resulted in non-timely release of GST compensation to the States. The Union government released ₹14,103 crore on April 7, 2020. An earlier tranche of ₹19,950 crore was released in February 2020. In this manner, the Union government paid the pending amounts of ₹34,000 crore for GST compensation for October and November 2019.[24] An amount between ₹30,000-₹40,000 crore is still owed to the States as compensation for December 2019 and January 2020,[25] which the Union government says will be "released soon".[24]

Ways and Means Advances

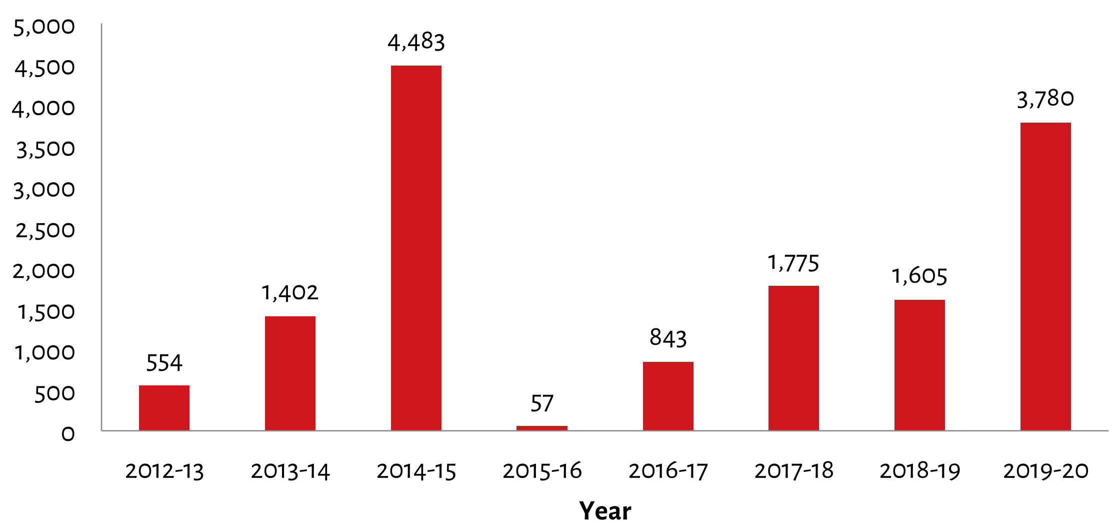
Ways and Means Advances (WMA) are temporary loan facilities provided by the RBI to the Union and State governments in case of short-term mismatch in cash flow of receipts and payments. Under the terms of the RBI Act,[26] the legal position vests the RBI with the right and obligation to function as the debt manager and banker for all States (other than for the State of Sikkim). The RBI provides WMA to the State governments to help them tide over temporary mismatches in the cash flow of their receipts and payments. They are intended to provide a cushion for States to assist them in carrying out essential activities and financial operations through these short-term loans.

The WMA procedure of drawing funds are of two types: normal WMA and special WMA or loans provided against GoI securities, renamed the Special Drawing Facility (SDF) in 2014.

In addition to these, an Overdraft (OD) facility is also extended to States when RBI credit exceeds the WMA and SDF limits.

The RBI Handbook of Statistics shows that there has been a steady increase in the drawing of funds through WMA since FY 2015-16 but has remained much below the WMA drawing limits.[27]

Figure 25: Ways and Means Advances from RBI



Source: *RBI Handbook of Statistics, Available online at https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=19254 . Last accessed on 9 May 2020.*

Over the last few years, Andhra Pradesh, Manipur and Punjab have borrowed through the WMA scheme. As of March 2020, only five States had drawn funds through WMA.

Table 8: Ways and Means Advances - State Borrowings

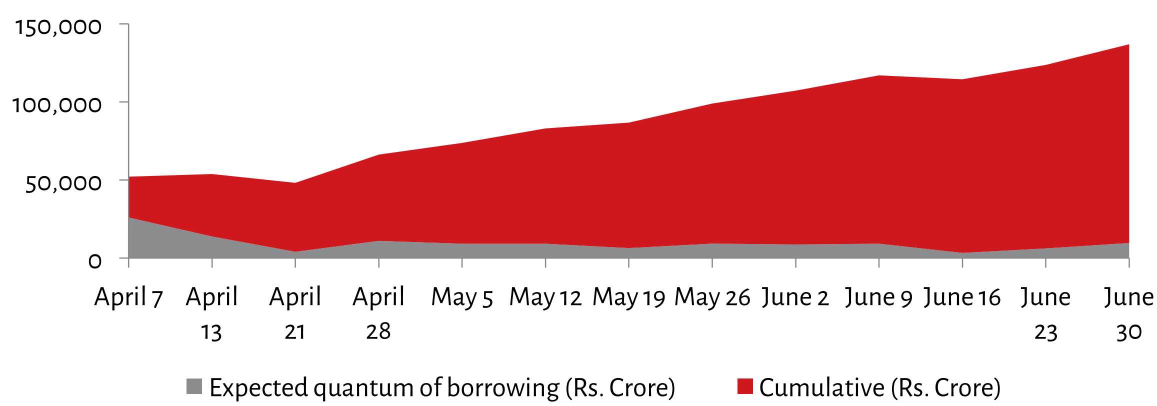
State/UT	End March 2017	End March 2018	End March 2019	End March 2020
Andhra Pradesh	-	231	370	1,870
Arunachal Pradesh	-400	56	449	742
Chhattisgarh	-	-	-925	-765
Jammu and Kashmir	890	301	301	301
Manipur	102	486	708	930
Mizoram	-17	-	-	-
Punjab	268	703	703	703
All States	**843**	**1,775**	**1,605**	**3,780**

Source: *State Finances Report 2019, RBI.*
Note: *Sum for All States may vary due to rounding off figures.*

The WMA scheme has been periodically reviewed, keeping in view the States' requirements, the evolving financial and institutional developments, as well as the objectives of monetary and fiscal management. The drawing limits of WMA have, from time to time, been revised by the RBI in consultation with the State governments.

The previous WMA drawing limit for States has recently been raised by 60 percent,[28] amounting to approximately ₹51,560 crore.[29] This increase is a part of the COVID-19 related liquidity injections that have been recently announced by the RBI. Through this, along with other measures such as increasing the number of days in which a State can be in overdraft continuously, the RBI hopes to ease the short-term crunch in liquidity so that States can continue to spend on health and social welfare, and ensure minimum support to residents. This also reduces their dependence on bond markets. Consequently, the current projections of State market borrowings have shot up significantly.

Figure 26: Projections of State Market Borrowings - April-June 2020



Source: *RBI Press Release, Available online at https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49618. Last accessed on 9 May 2020.*

The issue with the new WMA norms is that the 60 per cent increase in the limit in comparison with the estimated State borrowing through the period April-June 2020 - which stands 1.27 lakh crore[30] - is proving to be insignificant. Thus, market borrowings are the only way States can meet expenditure requirements. However, borrowing in a climate of heavy uncertainty is proving costly for States. Kerala, reportedly, was one of the States that paid a steep 8.96 per cent on its 15-year paper.[31] The other issue with WMA and OD is that the cushion is spread over 3 months and 21 days, respectively, before the principal amount is to be paid back with interest. At a time like this when kick-starting the economy itself could take longer, these short-term withdrawal facilities could prove inadequate.

KEY TAKEAWAYS

- Two fiscal factors are exerting pressure on the payment of GST compensation from the Union to the States – a slowdown in States' revenue receipts and decline in Union governments gross GST collection.
- The issue with the new WMA norms is that the **60**% increase in the limit in comparison with the estimated State borrowing through the period April-June 2020 - which stands 1.27 lakh crore - is proving to be insignificant.

5. Expenditures

As previously mentioned, the Indian Constitution specifies the delegation of fiscal powers and responsibilities between the Union and States. While the Union government has overwhelming responsibility of revenue generation including the assignment of all major taxes and to impose restrictions on State borrowings, State governments have the primary responsibility of delivering core public services. List-II of the Seventh Schedule of the Constitution lists over 60 responsibilities over which State governments, through their legislatures, have exclusive power to make laws including public health, agriculture, relief for the unemployable and other vulnerable sections, amongst others. In addition, the Concurrent list (List -III) lists subjects which are the shared responsibility of the Union and State governments.

The current COVID-19 crisis will require States to significantly increase their expenditures as a principal part of the impact falls directly under the States' jurisdiction. In fact, several States have already announced fiscal relief packages, amounting to ₹43,350 crore, till 30th April 2020.[32]

This chapter looks at States' expenditure across a range of parameters to understand the inter-state trends and possible areas of concern, even prior to the COVID-19 crisis. The chapter is divided as follows - first, we look at the proportion of expenditure that States anticipated as being financed through their projected revenues to determine the extent of dependencies on external sources of funding such as borrowings. Next, we look at the two broad types of expenditure, namely, revenue and capital expenditure, with a particular focus on committed liabilities. The final section looks at the nature of expenditure (developmental and social), with a special focus on health expenditure.

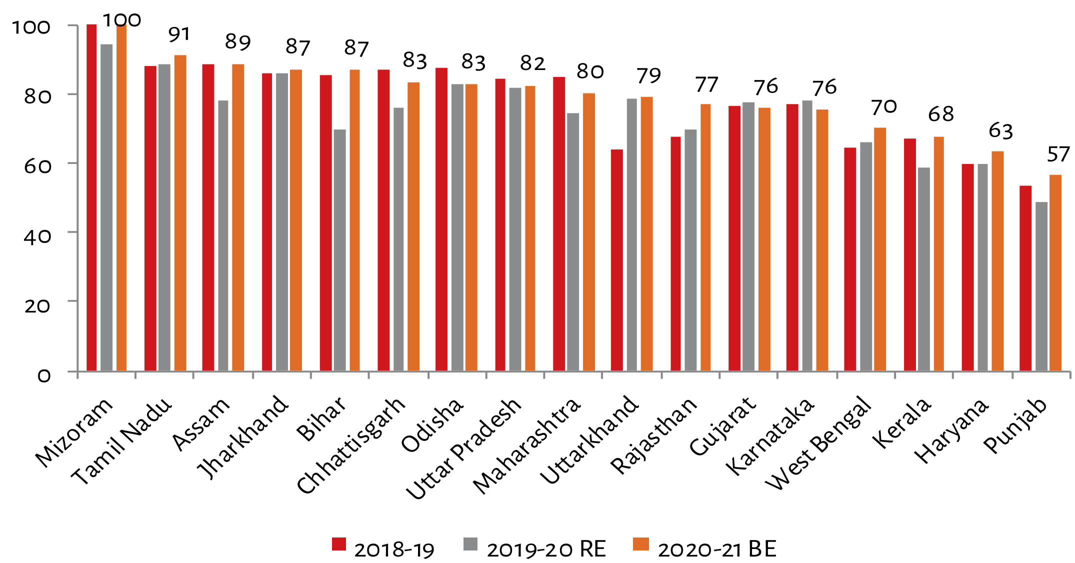
Expenditure Pattern of States

As we saw in the previous section, there are vast regional disparities across States in their ability to raise revenues, resulting in States having to rely on other sources, such as external borrowing, to finance their expenditures.

Analysis of the 17 States shows that in FY 2020-21 BE, around 75 per cent of the total expenditure of States was expected to be met through revenue receipts, up from 72 per cent in FY 2019-20 RE. During this period, revenue receipts covered a significant share of expected expenditures in the States of Mizoram (100 per cent), Tamil Nadu (91 per cent), Assam (89 per cent), Jharkhand (87 per cent), and Odisha (83 per cent). On the other hand, States such as West Bengal, Kerala, Haryana and Punjab would have to rely on external borrowings to finance 30-40 per cent of their total expenditure.

> "Several States have already announced fiscal relief packages, amounting to ₹43,350 crore, till 30th April 2020.
>
> Analysis of the 17 States shows that in FY 2020-21 BE, around 75 per cent of the total expenditure of States was expected to be met through revenue receipts."

Figure 27: Financing of Expenditures from Revenue Receipts for FY 2018-19 to FY 2020-21



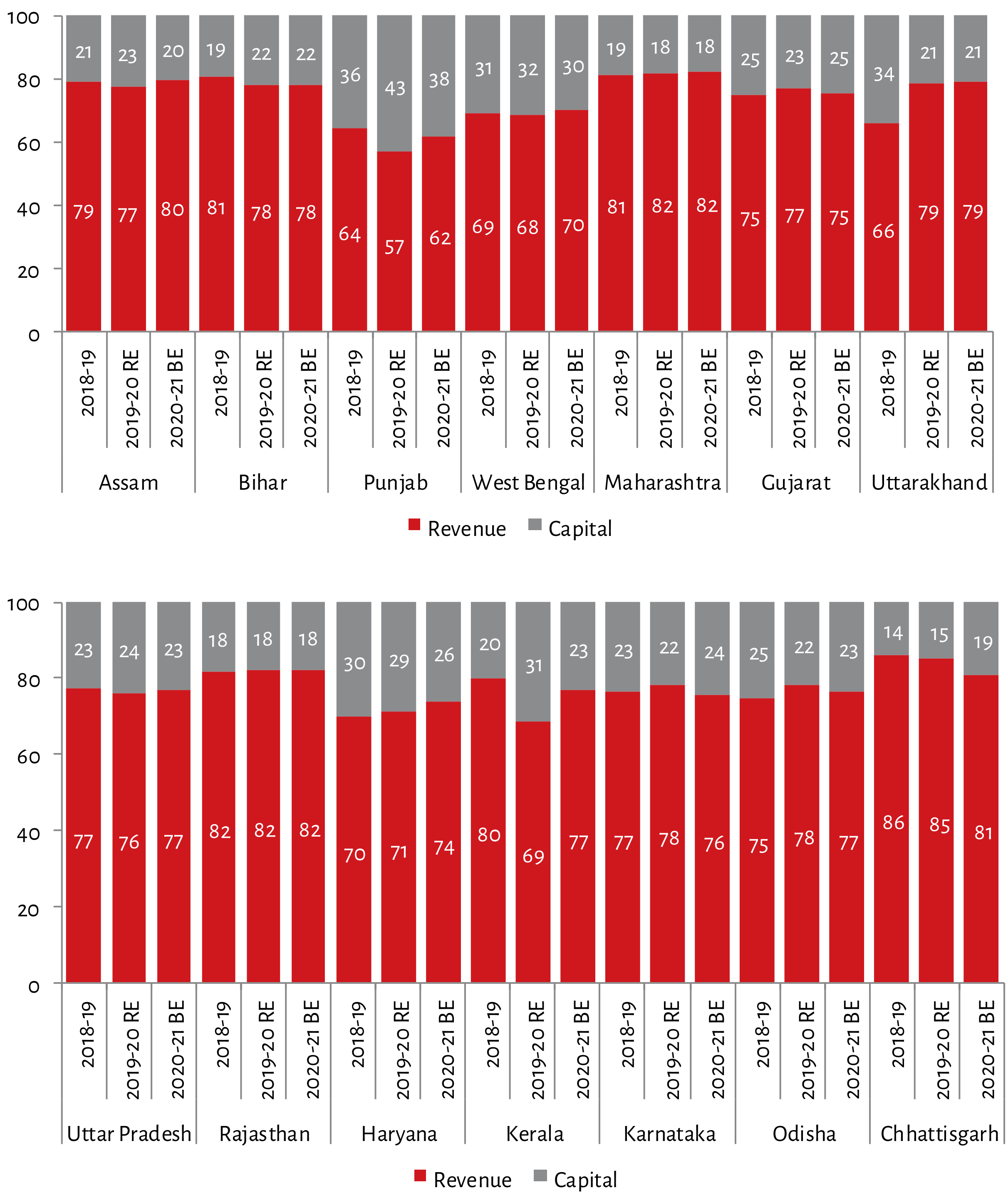
Source: *State Budget Documents.*

Types of Expenditure

State expenditure can be broadly classified into two types - revenue expenditure and capital expenditure. Revenue expenditure is recurring in nature and includes expenditure on salaries, pensions, and interest payments. Capital expenditure includes creation of assets, repayment of loans and advances and public debt. For most States, expenditure on the revenue component accounts for around 70-80 per cent, and the remaining 20-30 per cent is incurred as capital expenditure.

> State expenditure can be broadly classified into two types - revenue expenditure and capital expenditure. For most States, expenditure on the revenue component accounts for around 70-80 per cent, and the remaining 20-30 per cent is incurred as capital expenditure.
>
> A large segment of the revenue expenditure is often spent on committed liabilities. Committed liabilities typically include expenditure on salaries, wages and pensions as well as interest payments on loans. State governments are obliged to pay these even if they face a resource shortage.

Figure 28: Composition of Expenditure of States – FY 2018-19 and FY 2020-21



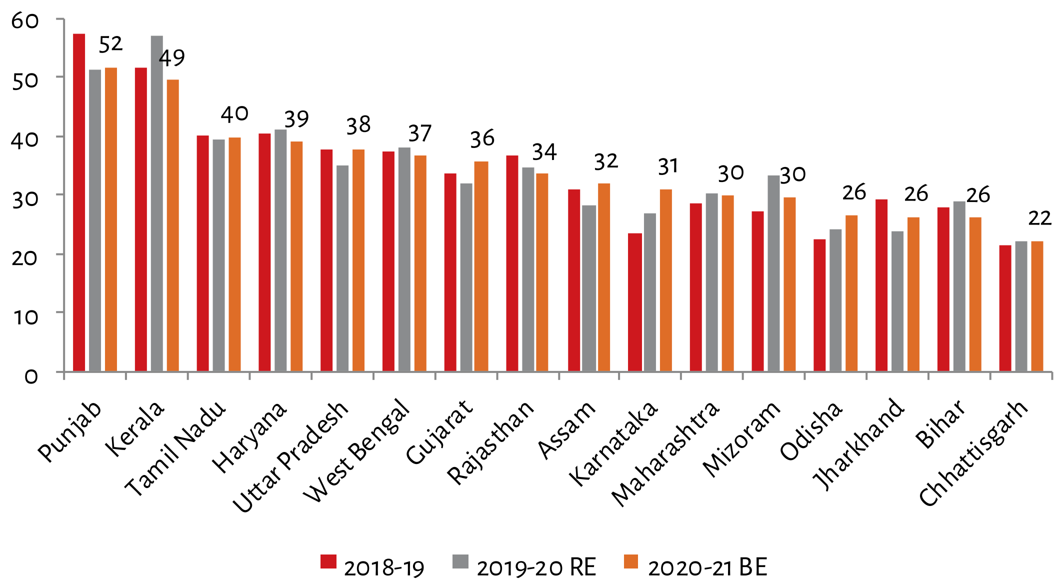
Source: *State Budget Documents.*

A large segment of the revenue expenditure is often spent on committed liabilities. Committed liabilities typically include expenditure on salaries, wages and pensions as well as interest payments on loans. State governments are obliged to pay these even if they face a resource shortage. The larger the share of committed liabilities, the less the fiscal room available for other expenditure. Therefore, sound public financial management would limit deficit spending on revenue expenditure particularly on committed expenditure and balance the income resources to cover other forms of expenditure.

The States, on average, spend around 35 per cent of their revenue receipts on committed expenditures in the last three financial years. There are however, inter-state variations. In FY 2018-19, Punjab spent around 57 per cent of its total revenue receipts on committed expenditure, highest among the sample States, followed by Kerala (52 per cent), Tamil Nadu and Haryana (40 per cent each). In contrast, States such as Mizoram, Odisha, Jharkhand, Bihar and Chhattisgarh spent less than 30 per cent of their revenue receipts on committed liabilities.

In FY 2020-21 BE, States with a larger share of committed expenditure to projected revenue and, thus, with relatively less flexibility to reprioritise their finances in combating the COVID-19 pandemic include Punjab, Kerala, and Tamil Nadu.

Figure 29: Committed Expenditure as a Proportion of Revenue Receipts



Source: *State Budget Documents.*

Composition of Expenditure

This sub-section presents the composition of expenditure in two ways: Developmental Expenditure and Social Sector Expenditure. Prior to the disbandment of the Planning Commission, expenditure was classified as Developmental and Non-Developmental Expenditure. Developmental expenditure refers to the expenditure of the government which helps in economic development by increasing production and real income of the country. Social and community services, economic services and developmental assistance to States form a part of this. Developmental expenditure is further divided into developmental expenditure on revenue account and on capital account.

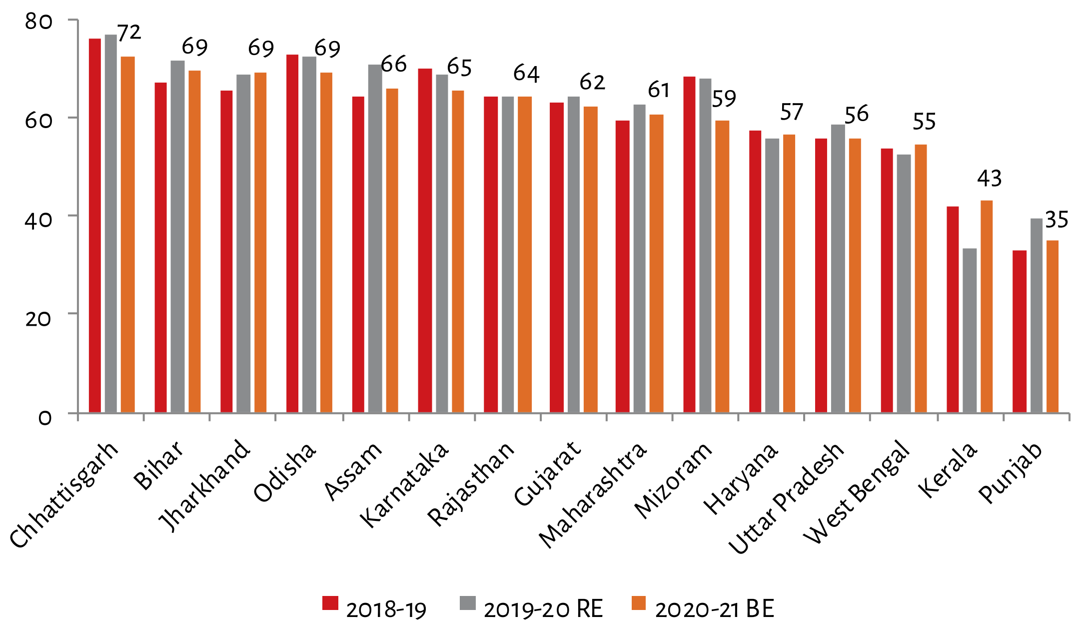
Non-developmental expenditure, on the other hand, refers to the expenditure of the government that does not directly contribute to the economic development of the country. It includes expenditure on administrative services, interest payments and pensions.

Social sector expenditure, on the other hand, refers specifically to expenditure on social services including health, education, sanitation and water supply, housing, urban development and welfare of backward communities.

Developmental Expenditure

There are State-wise variations on the budgets allocated towards developmental expenditure in each financial year. In FY 2020-21 BE, Chhattisgarh allocated 72 per cent of its expenditure towards developmental activities. On the other end of the spectrum, Kerala and Punjab allocated 43 per cent and 35 per cent, respectively. Most States anticipated a greater increase in development expenditure over the previous year. On average, 62 per cent of the budget of the States analysed was allocated towards developmental expenditure in FY 2020-21 BE, up from 59 per cent in FY 2019-20 RE.

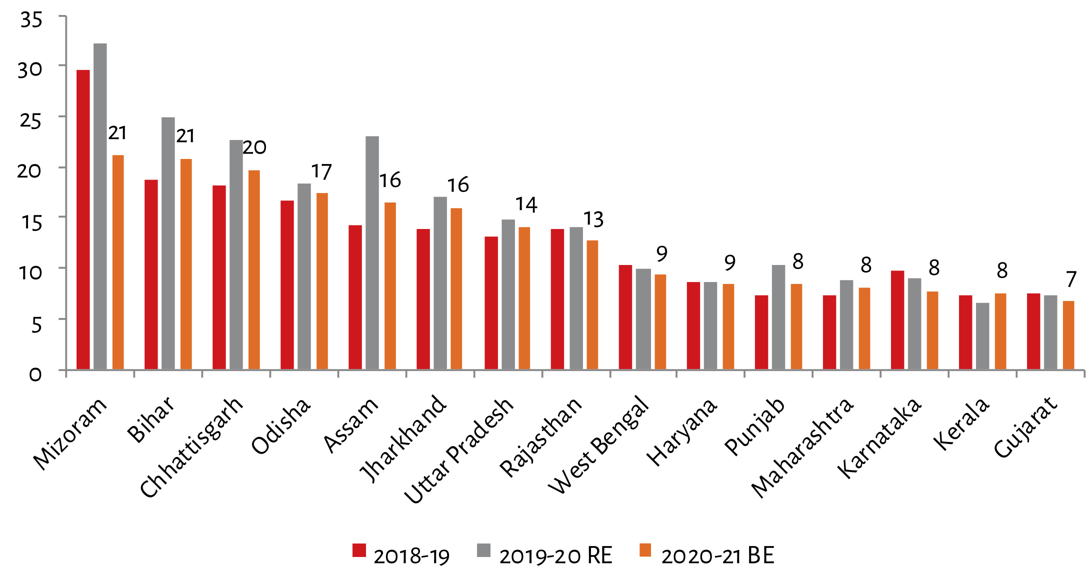
Figure 30: Developmental Expenditure as a Proportion of Total Expenditure



Source: *State Budget documents.*

An analysis of developmental expenditure as a proportion of GSDP, however, indicates a fall over the last three fiscal years. Between FY 2019-20 RE and FY 2020-21 BE, the decrease was sizable in the case of Mizoram from 32 per cent of GSDP to 21 per cent. The situation is similar in Assam, Bihar, and Chhattisgarh. Within developmental expenditure, the reduction in capital outlay observed was most prominent areas including roads, irrigation and energy. The decline in revenue developmental expenditure was largely driven by lower spending on education, power and relief on account of natural calamities. On the other hand, non-developmental expenditure increased due to higher interest and pension payments in recent years.

Figure 31: Developmental Expenditure as a percentage of GSDP



Source: *State Budget documents.*

Social Sector Spending

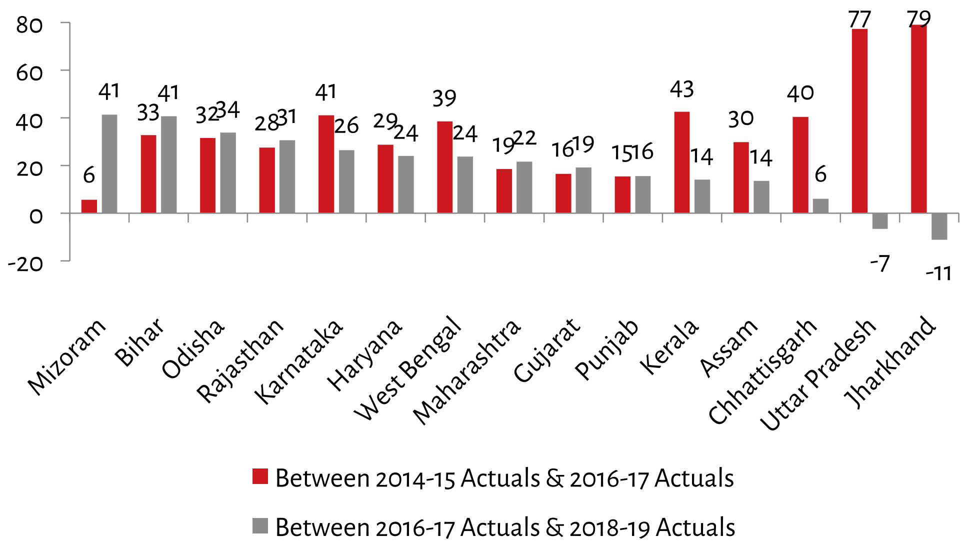
From the Union government perspective, financing for the social sector is primarily through CSSs. As mentioned in Section 3, immediately following the acceptance of the recommendations of the 14^{th} FC and the consequent increase in tax devolution to States, the Union government decreased the quantum of funds allocated to CSSs. Analysis of FY 2015-16 budgets showed some reduction in overall Union Transfers to States, which particularly impacted the social sector. For instance, a study by Choudhury, Mohanty, and Dubey (2018), looking specifically at CSS transfers for the social sector found that as a percentage of GSDP central plan transfers (or CSSs) for the social sector fell for almost all major States between FY 2014-15 and FY 2015-16.[33]

The decline in Union transfers was met with fear amongst States and civil society organisations that this would negatively impact social sector expenditure as States were dependent on CSSs as a source of non-wage funds. Moreover, CSSs allowed States to ring-fence expenditure particularly for the social sector.[34]

However, a look at the data suggests that total social sector expenditure (SSE) increased between FY 2014-15 and FY 2018-19 in a majority of States, allaying concerns of any adverse impact on fiscal transfers following the 14^{th} FC. The highest increases were visible in States such as Uttar Pradesh, Jharkhand and Karnataka. Only States such as Assam and Mizoram have reported a decrease for the same period.

> Following the recommendations of the 14^{th} FC and the consequent increase in tax devolution to States, the Union decreased the quantum of funds allocated to CSSs. However, total social sector expenditure increased in a majority of States, allaying concerns of any adverse impact.

Figure 32: Change in Social Sector Spending – FY 2014-15 to FY 2018-19

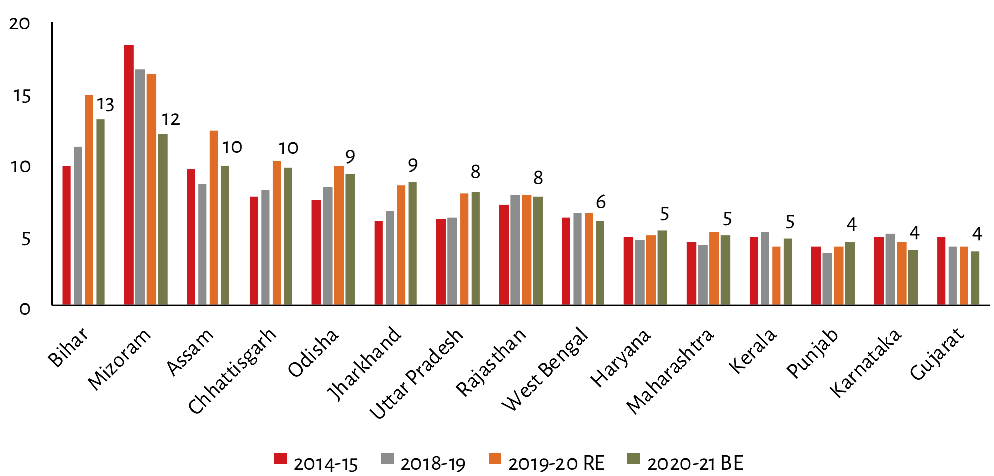


Source: *State Budget documents.*

SSE has mostly kept pace with GSDP and increased marginally. In FY 2014-15, prior to the 14th FC recommendations, the ratio was 7.03 per cent. This increased to 7.09 per cent in FY 2018-19. The recent two fiscal years, however, anticipate a slowdown. In FY 2019-20 RE, on average, the States spent 8 per cent of their GSDP on the social sector. This was expected to decrease to 7.4 per cent in FY 2020-21 BE.

There are, however, significant State variations. In FY 2019-20 RE and FY 2020-21 BE, poorer States (which also have worse development indicators) such as Bihar, Mizoram and Assam have allocated over 10 per cent of their GSDP to SSE. On the other hand, States such as Maharashtra, Kerala, Punjab, Karnataka and Gujarat have allocated between 4-5 per cent. Worryingly, despite a higher share of SSE as a proportion of the GSDP, several States such as Bihar, Mizoram, Assam, Chhattisgarh, and Odisha were anticipating a fall in the proportions in FY 2020-21 BE as compared to the previous year. They, however, remain above the Actuals for FY 2018-19.

Figure 33: Social Sector Expenditure as a Percentage of GSDP

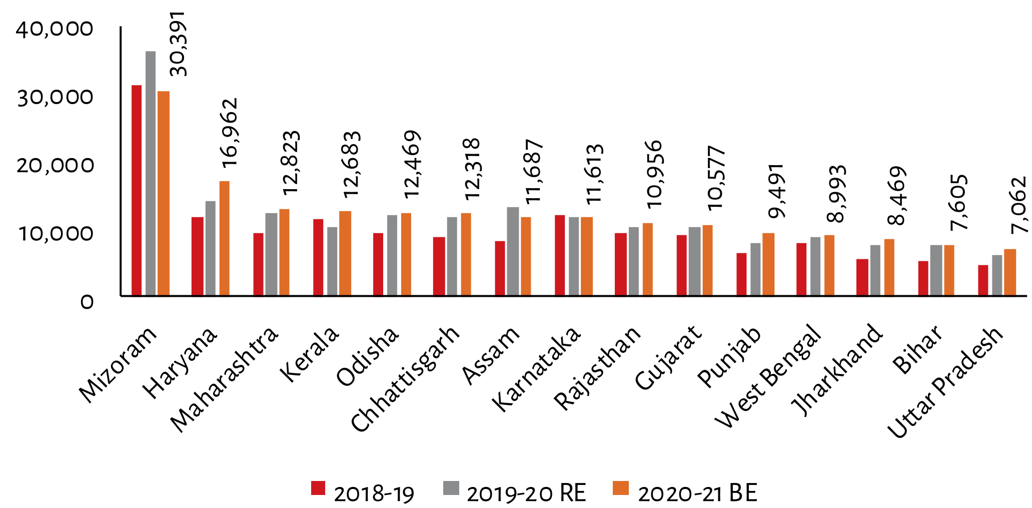


Source*: State Budget documents.*

A break-up of social sector expenditure per capita shows that, for the States analysed, the average per capita was expected to increase from ₹10,055 in FY 2018-19, to ₹12,032 in FY 2019-20 RE and further to ₹12,273 in FY 2020-21 BE. Across States, it ranges from ₹7,062 in Uttar Pradesh to ₹30,391 in Mizoram.

Within the social sector, we also observe a shift away from expenditure on education to sectors such as housing (driven possibly by increasing allocations for the Pradhan Mantri Awas Yojna), urban development, and social security and welfare.

Figure 34: State-wise per capita Social Sector Expenditure



Source: *State Budget documents.*

Health Expenditure

With almost one-fifth of the world's population living in India, India accounts for a relatively high burden of diseases. Yet, it is well known that India spends relatively less on healthcare. According to the Indian Constitution, the health sector falls under the State List and, thus, the provision of financing public health expenditure is primarily the responsibility of State governments, with some overlapping responsibilities with the Union through a number of CSSs such as the National Health Mission (Urban and Rural), National Mission on AYUSH and, recently, the Ayushman Bharat scheme.[35]

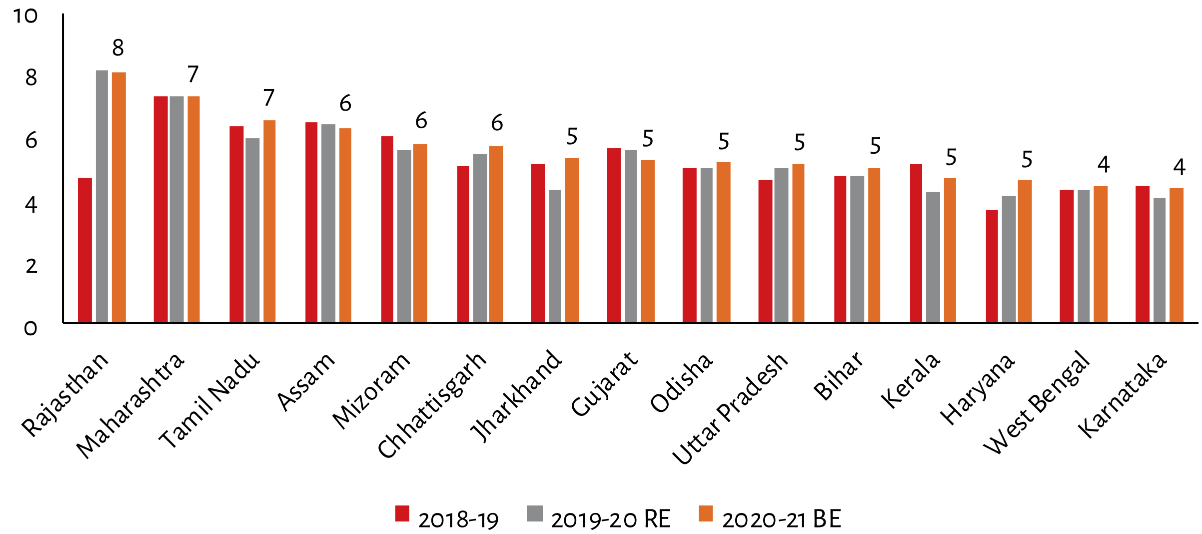
As per the Economic Survey 2019, expenditure on health by the Union government and States combined as a proportion of total expenditure increased marginally from 4.5 per cent in FY 2014-15 to 5.4 per cent in FY 2017-18. The proportions, however, were expected to decrease marginally to 5.3 per cent in FY 2018-19 RE and FY 2019-20 BE.[36] As a proportion of GDP, health expenditure increased from 1.2 per cent in FY 2014-15 to 1.6 per cent in FY 2019-20 BE.

The outbreak of the COVID-19 pandemic is going to necessitate a significant increase in health expenditures across both the Union and State governments. This sub-section looks at the existing trends in health expenditure across the 17 States to understand the level of prioritisation for the sector, prior to the pandemic.

We have used two indicators for understanding health expenditures. First, we computed the proportion of health expenditure out of the total expenditure across the sampled States. Second, we analysed health expenditure as a proportion of the State's GSDP.

As can be seen in Figure 35, as a proportion of total expenditure, in FY 2020-21 BE, Rajasthan, Maharashtra, and Tamil Nadu had anticipated spending around 7 per cent of their total expenditure on health. In contrast, States such as Karnataka and West Bengal had anticipated spending close to 4 per cent.

Figure 35: Proportion of Health Expenditure out of Total Expenditure

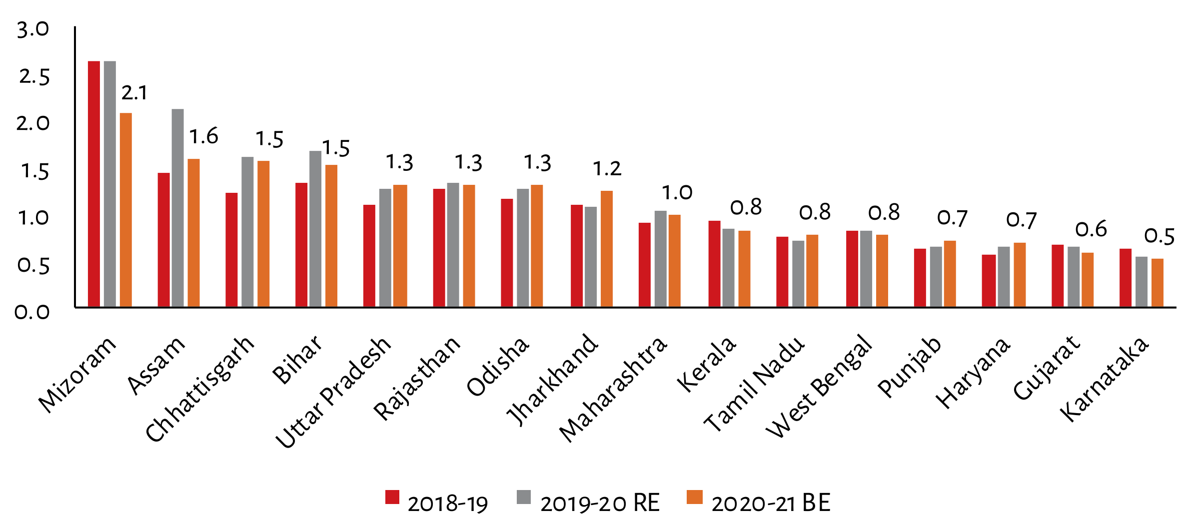


Source: *State Budget documents.*

The public expenditure on health and family welfare as a proportion of the GSDP has remained below 2 per cent for most of the sampled States. Surprisingly, in a few States expenditure on health as a proportion of GSDP was projected lower in FY 2020-21 BE compared to the REs for the previous year. For instance, while Assam had expected to spend 2.1 per cent of its GSDP in FY 2019-20 RE, the figure for FY 2020-21 BE was 1.6 per cent. Similarly, in Chhattisgarh, expenditure proportions out of GSDP were expected to fall from 1.6 per cent to 1.5 per cent, during the same period.

Overall in FY 2020-21 BE, Mizoram is the only State with more than 2 per cent health expenditure as a proportion of GSDP and that too was lower than the FY 2019-20 RE figures. In contrast, Karnataka had expected to spend only 0.5 per cent of their GSDP on health in FY 2020-21 BE.

Figure 36: Proportion of Health Expenditure out of Gross State Domestic Product (at Current Prices)



Source: *State Budget documents.*

The composition of total health expenditure shows that almost 85-90 per cent of health expenditure is recurring in nature (i.e. revenue expenditure). Expenditure on the capital account is predominantly for the creation of physical infrastructure, and purchase of drugs and equipment. With existing health facilities significantly overburdened, the low capital expenditure is likely to add further stress to the health system. As per data on hospital beds in government facilities included in the National Health Profile 2019, the average population served per government hospital bed in rural areas was 3,143 (the reference period for various States ranged from 1 January 2014 to 31 December 2018). This implies an availability of less than 0.3 beds per 1,000 people in rural areas.[37]

KEY TAKEAWAYS

- The States, on average, spend around **35**% of their revenue receipts on committed expenditures in the last three financial years.
- Developmental expenditure as a proportion of GSDP fell over the last three fiscal years.
- Almost **85-90**% of health expenditure is revenue expenditure. With existing health facilities significantly overburdened, the low capital expenditure is likely to add further stress to the health system.

SECTION 6

6. Conclusion and Discussion

The present note has reviewed recent trends across different components of revenue and expenditure for a sample of State governments for which recent budget data had been released. As mentioned at the start, recent changes in the fiscal architecture – including the implementation of GST, the increase in State share for CSSs and the debts taken over by States for UDAY, as well as the announcement of a number of farm loan waiver schemes – had already placed a significant burden on State finances.

Our analysis demonstrates that following the 14th FC recommendations and the subsequent increase in States' share of the divisible pool of taxes, the proportion of taxes devolved to States out of their total revenues increased between 2015 and 2019. Over FY 2019-20 RE and FY 2020-21 BE, however, this proportion was expected to decline, even prior to the COVID-19 crisis. Part of the reason is that tax devolution to States is counteracted by an increase in levying of cesses – which has been increasingly undertaken following the implementation of GST – as these are not included in the divisible pool of taxes. Given the economic consequences of the pandemic, it would be difficult for the Union government to achieve the anticipated 12 per cent growth in tax revenue targeted for FY 2020-21, adding to both Union and State government fiscal stress.

The analysis also revealed that structural changes to CSSs saw a reduction in the Union's share and an attendant increase in the States' share of funds – in some cases, States' share rose from 25 per cent to as high as 40 or 50 per cent. The subsequent redirection of State monies from untied funds to these schemes further hinders their fiscal flexibility. On the other hand, the allocation under Disaster Response Funds more than doubled following the recommendations of the 15th FC.

We further looked at recent policy moves impacting State revenues. The Union government's GST compensation to States is likely to experience incomplete and non-timely payments given the recent decline in GST collections, and is worsened by the COVID-19 outbreak. The RBI instated a significant increase in the drawing limit of Ways and Means Advances available to State governments – however, these short-term facilities may be inadequate to weather the present crisis.

On the expenditure side, while the change in the composition of fiscal transfers following the 14th FC recommendations did not lead to a decrease in social sector expenditures across most States, the last fiscal year i.e. FY 2020-21 BE has seen a contraction of expenditure including for the social sector, and health specifically, in a number of States. With committed liabilities forming a large share of expenditure, it will be challenging for States to reallocate resources towards the COVID-19 pandemic without additional revenue mobilisation.

The COVID-19 pandemic hit India when the economy was already constrained. In FY 2019-20, India recorded the lowest growth rate of GDP since the 1990s. The spread of the virus and lockdown measures have brought large parts of the economy to a complete standstill and constrained the government's ability to generate revenues and ensure the fiscal space required to mitigate the welfare and economic consequences of the pandemic. The Union government recently issued an advisory to cut down expenditures and channel finances towards more immediate needs. This implies that the actual expenditures for FY 2020-21 are likely to look significantly different from those budgeted.

With States at the frontlines to mitigate the short- and long-term impact of COVID-19, and ensure vulnerable communities have adequate means of social protection, it will be imperative for the Union government to ensure that States have adequate resources. The last few months have seen the announcement of a number of fiscal and monetary measures. These include the increase in WMA, a temporary removal of the current ceiling limit mandated by the Fiscal Responsibility and Budget Management (FRBM) Act by a few States,[38] making available special zero-interest windows, the Pradhan Mantri Garib Kalyan Yojana (PMGKY), and upfront release of Union transfers for existing CSSs.[39] Moreover, the Union government also rolled out a ₹15,000 crore package[40] to help States with their COVID-19 emergency response and health system preparedness over a four-year period. While ₹7,774 crore has been sanctioned for immediate response, the remaining money is to be used for medium-term support (1-4 years), under a mission-mode approach. States too have tried to increase revenues through additional borrowings, salary cuts, reduction in non-essential capital expenditure and imposition of additional tax on alcohol,[41] amongst others.

Going forward, there may be a need to seriously rethink the current design of social policy financing. One way that the Union government can support this is through a redesign of CSSs as an instrument of GIA by ensuring greater flexibility to States. A note published by the Centre for Policy Research outlines the mechanics of this in detail.[42] Briefly, this can be achieved by bundling together GIA through these schemes into an untied grant for States without being constrained by Central guidelines and numerous conditionalities. Funds currently budgeted for non-core COVID-19 activities (i.e., excluding health, labour, and social protection), and unspent balances available for several CSSs could be used to create this COVID grant. While the Union government has recently announced that it would not remove the State share,[43] one option could be to redesign the State share as a long term zero-interest loan to be repaid when the crisis abates – probably in FY 2021-22.

To guide the mechanics of Centre-State financing and the need for a coordinated response, keeping in mind State-specific situations also calls for the establishment of a new institutional mechanism to deal with Centre-State issues. One such body could be a specially created National Empowered Emergency Disaster Council (NEED Council) comprising Chief Ministers, the Prime Minister and senior Union Ministers. The NEED Council could be supported by the National Disaster Management Authority and be responsible for creating a predictable and equitable, COVID-specific funding window (including ensuring additional resources through NRDF and SRDF) and be responsible for ensuring monitoring and reporting of expenditures.[42]

The next few years are going to be a critical time for State finances and may require a substantial divergence from a business-as-usual approach to one which is similar to those for war economies.[44] As the lockdown is lifted, it will be imperative for Union and State governments to continue to deploy resources for the vulnerable to ensure basic income support and undertake measures to revive the economy. Further, the final report of the 15th FC due in October 2020 and the release of Supplementary budgets by the Union government, are expected to significantly alter the current estimations in the State budgets for FY 2020-21 BE. Given the critical role played by States, it is going to be imperative to regularly track State finances.

Disclaimer: This working paper will be updated with new information that may emerge in the next few months.

Endnotes:

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ANNEXURE

Annexure 1: Share in Divisible Pool Comparison of 14th and 15th Finance Commission

State	14th FC - Share in divisible pool	15th FC - Share in divisible pool	State	14th FC - Share in divisible pool	15th FC - Share in divisible pool
Andhra Pradesh	4.31	4.11	**Manipur**	0.62	0.72
Arunachal Pradesh	1.38	1.76	**Meghalaya**	0.64	0.77
Assam	3.31	3.13	**Mizoram**	0.45	0.51
Bihar	9.67	10.06	**Nagaland**	0.5	0.57
Chhattisgarh	3.07	3.42	**Odisha**	4.64	4.63
Goa	0.38	0.39	**Punjab**	1.57	1.79
Gujarat	3.1	3.4	**Rajasthan**	5.5	5.98
Haryana	1.1	1.08	**Sikkim**	0.36	0.39
Himachal Pradesh	0.71	0.8	**Tamil Nadu**	4.02	4.19
Jammu and Kashmir	1.86	-	**Telangana**	2.43	2.13
Jharkhand	3.14	3.31	**Tripura**	0.64	0.71
Karnataka	4.71	3.65	**Uttar Pradesh**	17.95	17.93
Kerala	2.5	1.94	**Uttarakhand**	1.05	1.1
Madhya Pradesh	7.55	7.89	**West Bengal**	7.33	7.52
Maharashtra	5.52	6.14			

Source: *14th Finance Commission Report and 15th Finance Commission Report (Report for the Year 2020-21).*

Annexure 2: Sources for State Budget documents for Sampled States

States	Data Sources
Assam	https://finassam.in/budget_documents/
Bihar	http://finance.bih.nic.in/
Chhattisgarh	http://finance.cg.gov.in/budget_doc/Budget.asp
Gujarat	https://financedepartment.gujarat.gov.in/Budget.html
Haryana	http://www.finhry.gov.in/State-Budget12
Jharkhand	https://finance-jharkhand.gov.in/budget2020.aspx
Karnataka	https://www.finance.karnataka.gov.in/english
Kerala	http://www.finance.kerala.gov.in/bdgtDcs.jsp
Maharashtra	https://beams.mahakosh.gov.in/Beams5/BudgetMVC/MISRPT/MistBudgetBooks.jsp?year=0
Mizoram	https://finance.mizoram.gov.in/
Odisha	https://finance.odisha.gov.in/Budget.asp?GL=Budget&PL=1&TL=1&FL=1
Punjab	http://pbfinance.gov.in/state-budget
Rajasthan	http://finance.rajasthan.gov.in/aspxfiles/statebudget.aspx
Tamil Nadu	http://www.tnbudget.tn.gov.in/demands.html
Uttar Pradesh	http://budget.up.nic.in/
Uttarakhand	http://budget.uk.gov.in/
West Bengal	http://www.wbfin.nic.in/New_Fin/Pages/Budget_Publication.aspx

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To cite: Kapur A., Irava, V., Pandey S., and Ranjan, U. (2020), "Study of State Finances 2020-21", Accountability Initiative, Centre for Policy Research.
Retrieved via URL: <https://accountabilityindia.in/publication/study-of-state-finances/>

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