I Overview

1.1 A noteworthy feature of public finances of states during 2014-19 is the strong drive towards consolidation, a trend continuing from the preceding five-year period (2009-14)[1]. Over the recent five-year period, the combined gross fiscal deficit of the states [excluding Ujwal DISCOM Assurance Yojna (UDAY) in 2015-16 and 2016-17] averaged 2.5 per cent of GDP, *i.e.*, in striking range of the recommendation of the FRBM Review Committee (Chairman: Shri N.K. Singh). This has, however, been achieved by sharp retrenchment in expenditure, mainly capital expenditure, with potentially adverse implications for the pace and quality of economic development, given the large welfare effects of a much wider interface with the lives of people at the federal level. Currently, states employ about five times more people and spend around one and a half times more than the Centre. Moreover, public expenditure by states influences the quality of physical and social capital infrastructure of the economy, with higher multiplier effects on one hand and on the other, a more medium-term perspective to tap into India's demographic dividend (Government of India, 2019) and achieve the United Nations' Sustainable Development Goals (SDGs) duly endorsed by the G20. The above the line rectitude achieved by states in recent years has been accompanied by an increase in indebtedness of states, but with no incentives for prudence or better performance with inter-generational consequences.

1.2 States have to balance aspirational policy choices against two major operating constraints: generating adequate revenue within the Legislative Framework and adhering to Fiscal Responsibility Legislations (FRLs). Prudent fiscal housekeeping has to be, therefore, balanced with developmental and sustainability perspectives. Key to an optimal mix is states' own revenue generation capacity coupled with adequate support from federal transfers so that the states can absorb exogenous fiscal shocks in the form of schemes like farm loan waivers, the UDAY, farmer income support schemes and structural reforms such as the Goods and Services Tax (GST), without sacrificing the hard-earned gains of fiscal consolidation so that their finances remain sustainable over the medium-term. Given that annual budgetary outcomes of states are essentially a time-varying process of accumulation of debt, it is the sustainability of debt that holds the key.

1.3 Against this backdrop, this year's Report addresses the theme of "Debt: States' Medium-Term Fiscal Challenge". The

[1] Using gross fiscal deficit (GFD) to gross domestic product (GDP) ratio of 2.4 per cent based on provisional account (PA) for 2018-19, the average GFD/GDP ratio for the five years period 2014-15 to 2018-19 works out to 2.5 per cent (excluding UDAY), as compared to the GFD/GDP ratio of 2.3 per cent during the preceding five years (2009-10 to 2013-14).

slowdown in the economy can weaken their revenue at a time when they are confronted with the challenges related to the structural issues of power sector, rising off-balance sheet/guarantees of state governments and the growing market borrowings of state governments, all of which have implications for debt sustainability, going forward.

1.4 In keeping with the practice instituted from last year's Report, budget estimates (BE) for 2019-20 are analysed alongside outcomes for 2018-19 and 2017-18 in Chapter II. States have budgeted GFD-GDP ratio of 2.6 per cent for 2019-20 as against revised estimate of 2.9 per cent in 2018-19 (2.4 per cent as per provisional accounts) and 2.4 per cent in 2017-18 (actuals). Drawing on this, the financing counterpart is examined in terms of market borrowings and debt liabilities of states. Outstanding debt hovered around 25 per cent of GDP since end-March 2017. The fiscal costs of schemes like farm loan waivers, farmer income support schemes and Ayushman Bharat have also been analysed.

1.5 Chapter III focuses on the theme. It conducts a debt sustainability analysis on states' debt and its likely path over the next five years, keeping in view the FRBM Review Committee's implied debt target of 20 per cent by 2024-25. Recognising that revenue can act as a circuit breaker in debt analysis, this Chapter drills down into the various sources of revenue – their own taxes, non-tax revenue and transfers including devolution and grants. The focus is on revenue augmentation by improving tax buoyancy and efficiency. The GST experience of states over the past two years is captured in this Chapter. The changing role of Central transfers in mitigating vertical imbalances among Centre and states has been touched upon. As 2019-20 is the terminal year of UDAY, an analysis of the same has been done. With large scale financing of state budgets through market borrowings, issues relating to maturity, liquidity and pricing of State Development Loans (SDLs) are also covered. Case studies from the states' experience with regard to reissuances and elongation are also featured in this Chapter. A time series on sub-national guarantees, compiled for the first time in India, is also presented in this Chapter.

1.6 Chapter IV concludes the report by setting out policy perspectives in the context of debt sustainability. The important role of states in promoting growth given their large share in General Government capital expenditure with high multiplier effects is highlighted.

1.7 Data on fiscal indicators for all states and union territories with legislature for 2019-20, including various budgetary components, are presented in appendices and statements in the Report.

1.8 One of the main highlights of this year's report is the release of time series data on all the components in the revenue and capital account of state finances since 1990-91 (see page 84).