I Overview

State governments are expected to strengthen their fiscal position in 2012-13, broadly in line with the fiscal roadmap laid down by the Thirteenth Finance Commission. The improvement is reflected in the continued increase in surpluses in the revenue account of the majority of states, reduction in the fiscal deficit-GDP ratio and a declining trend in the debt-GDP ratio. The higher capital outlay budgeted for the year in many of the revenue surplus states indicates that the quality of expenditure is not being compromised in attaining the deficit targets. While some comfort can be drawn from the fiscal position of the state governments, states may have to exploit their potential for raising revenues and move towards convergence of tax rates in preparation for the shift to the goods and services tax regime. The states, particularly those that fare poorly in terms of the human development index, need to increase their social sector expenditure in building human capital stock that, in turn, would help augment the supply of skilled labour and achieve more inclusive growth in future. There is also a need to improve the measurement and reporting of implicit obligations of the states to reflect their true fiscal positions, particularly in light of increasing off-budget liabilities on account of guarantees to state power distribution companies (discoms). As regards state debt sustainability, prudent expenditure management measures, which contain non-productive expenditure while simultaneously providing for counter-cyclical growth inducing expenditure, may be required to maintain and strengthen debt sustainability.

1. Introduction

1.1 After a marginal setback in 2011-12 due to the economic slowdown, the overall fiscal balance of the states is budgeted to improve in 2012-13, as reflected in the reduction in gross fiscal deficit (GFD) and primary deficit (PD) as ratios to GSDP and increase in capital outlay in the majority of the states. The higher growth in revenue receipts than in revenue expenditure during 2012-13 is expected to boost the revenue surplus of states at the consolidated level. States have sought to augment their revenues through tax and non-tax measures even while continuing to address the issue of inflation in essential commodities through exemption/reduction in value added tax (VAT) rates on specific commodities. States are also increasingly taking recourse to information technology to improve tax compliance and reduce the costs of tax administration. The eventual fiscal outcome would, however, be shaped by the macroeconomic conditions and the joint commitment of the centre and the states to implement fiscal reforms that are in the pipeline. This report, “State Finances: A Study of Budgets of 2012-13”, has been prepared based on the data available in the budget documents of 28 state governments and two Union Territories with legislature, *viz.*, NCT Delhi and Puducherry.

2. Preview

1.2 All the key deficit indicators of states at the consolidated level are budgeted to improve in 2012-13, indicative of the states’ intent to carry forward fiscal consolidation as envisaged by the Thirteenth Finance Commission (FC-XIII). While the consolidated revenue surplus is budgeted to increase to 0.4 per cent of GDP in 2012-13 from 0.1 per cent in 2011-12(RE), GFD and PD as ratios to GDP are budgeted to decline to 2.1 per cent and 0.6 per cent, respectively, in 2012-13 from 2.3 percent and 0.8 per cent, respectively, in 2011-12(RE). At the disaggregated level, the GFD-GSDP ratio is budgeted to exceed the FC-XIII’s target in 2012-13 in one non-special category state (NSC) and two special category (SC) states.

1.3 The consolidated state government debt-GDP ratio, which has been secularly declining since end-March 2004, continued to do so in end-March 2012 (RE) to 22.6 per cent and is budgeted to further decline to 21.9 per cent by end-March 2013. At this level, the debt-GDP ratio is lower than the FC-XIII's recommended benchmark for the year as well as the medium-term target of 24.3 per cent for 2014-15. The decline in the debt-GDP ratio was also seen at the disaggregated level of the states, reflecting the impact of a faster increase in nominal GSDP relative to that of the state debt. Market borrowings continued to dominate the outstanding liabilities of the states indicating a significant compositional shift in favour of market borrowing. The weighted average yield of state government securities issued during 2011-12 was higher than in the previous year, due to increased market borrowings coupled with tight liquidity in the market. On the cash management front, states continued to accumulate surplus cash balances while they reduced their recourse to WMA and overdrafts in 2011-12 over the previous year. The recently-announced scheme for financial restructuring of the state-owned distribution companies (discoms) is likely to increase the contingent liabilities of the state governments in the near term and may have an impact on their actual liabilities in the medium-term.

1.4 The sustainability of sub-national debt assumed importance during the late 1990s and early 2000s when state governments experienced fiscal stress and debt repayment pressures. The reversal of the interest rate cycle in the mid-2000s and the incentivised debt relief and interest relief measures provided by the centre played a crucial role in alleviating the interest and debt burden, preventing an explosive trajectory for the debt of the state governments. This was complemented by efforts at fiscal consolidation and institutional reforms to get on the fiscal correction path. An indicator analysis for states shows progress on most indicators of fiscal and debt sustainability since the onset of fiscal and debt consolidation. While the consolidated debt-GDP ratio of the states has significantly declined in recent years, contingent liabilities arising from guarantees to state public sector utilities pose a risk to state finances, unless monitored and adequately controlled. Moreover, the aggregate picture masks interstate disparities and vulnerabilities, which require customised reforms and corrective packages rather than a uniform across-the-board prescription. Going forward, given that restructuring of most high-cost debt of the states have already been undertaken and there is limited fiscal space available with the centre, substantial debt relief and interest relief measures from the centre may not be forthcoming. Hence, states would have to focus more on their own revenue enhancing and expenditure compression measures to improve their debt sustainability. Further, as tax revenue is more sensitive to growth cycles, prudent expenditure management measures, which contain non-productive expenditure while simultaneously providing for counter-cyclical growth inducing expenditure, may be required to maintain and strengthen debt sustainability.

1.5 With the second phase of a rule-based fiscal consolidation path underway, some of the key challenges that need to be addressed by the state governments are improvement in tax efforts through increasing efficiency and other initiatives; reorientation of expenditure policies to improve the quality of expenditure while also aiming at fiscal sustainability in the medium-term; enhancement of fiscal transparency so as to enable effective monitoring of the quality, durability and effectiveness of the fiscal correction process; factoring in the fiscal implications of the financial restructuring package for state discoms;

and strengthening the supply chain through legislative interventions and building appropriate infrastructure.

1.6 The chapter-wise scheme of the report is as follows. While this chapter has provided an overview of the report, the major issues relating to the finances of the states in the current context are highlighted in Chapter II. Major policy initiatives undertaken by the state governments, the Government of India and the Reserve Bank of India are presented in Chapter III. Chapter IV provides an analysis of the fiscal position at the consolidated level and the underlying state-wise contribution. It also provides an assessment of fiscal performance *vis-à-vis* the revised roadmap of the Thirteenth Finance Commission. Chapter V presents an analysis and assessment of the debt position of the states, including market borrowings and contingent liabilities. Chapter VI focuses on the special theme, *i.e.,* Sub-national Debt Sustainability: An Assessment of the State Governments. The consolidated data on various fiscal indicators of 28 state governments are covered in Appendix Tables 1-21, while state-wise data are provided in Statements 1-47. The detailed state-wise budgetary data are provided in Appendices I-IV (Appendix I: Revenue Receipts; Appendix II: Revenue Expenditure; Appendix III: Capital Receipts; Appendix IV: Capital Expenditure).