I Overview

1.1 Fiscal policy in India has responded to multiple challenges, protecting households and businesses from the impact of the pandemic and war-induced surges in energy and food prices while reorienting expenditure towards capital formation to revive growth. As the global outlook deteriorates and private investment activity remains subdued amidst elevated uncertainties, the focus is back on public expenditure as the key instrument to sustain recovery and promote growth. The share of the general government capex in total gross fixed capital formation in India is about 11 per cent[1]. States account for 60 per cent of general government expenditure in India, as against the global average for sub-national spending of about 30 per cent (Das, 2021). States' capital outlay recorded a robust growth of 32 per cent in 2021-22, partly supported by the Centre's budgetary allocation for States under the 'Scheme for Financial Assistance to the States for Capital Investment', providing the necessary support to the recovering economy. In 2022-23, they have budgeted for an increase in capital outlay by 38 per cent.

1.2 Higher capital expenditure not only creates additional demand immediately but also paves the way for further growth and durable recovery (Rangarajan and Srivastava, 2022). A sustained improvement in the quality of public expenditure, with a focus on infrastructure, research and development, health, education and other social services can play a conducive role in promoting inclusive and sustainable economic growth, which is also a sustainable development goal (SDG) of the United Nations. The impact of capex in one State can have positive externalities and crowding in effect on that of others. This year's Report on 'State Finances : A Study of Budgets' examines the role and impact of capital outlay of State governments in India and the challenges they have to confront in this regard with the theme 'Capital Formation in India – The Role of States'.

1.3 State governments can promote investment through both direct and indirect channels. The direct channel involves spending on physical infrastructure and human capital. The indirect channels act by crowding in private investment, promoting good governance, and attracting foreign direct investment (FDI), especially into technology; telecommunication; banking, financial services and insurance (BFSI); retail and consumer facing services. Since these sectors are also major job creators, it is important for the State governments to create a congenial policy environment for them to thrive (HBL, 2022). India's goal of net zero emissions by 2070 also underscores the growing requirement for State governments to prioritise investments in low-carbon technology, supporting infrastructure, research, and transfers to shield the most vulnerable households from the impact of the transition (Kohli *et al.,* 2022).

1.4 The improvements secured in the financial positions of the State governments since 2021-22, as reflected in terms of lower deficit indicators (*viz.,* gross fiscal deficit/ revenue deficit/primary deficit as a per cent of GDP), has increased the fiscal headroom available for undertaking higher capex. Additionally, the Centre's scheme

[1] Average for the period 2016-17 to 2019-20.

for 'Financial Assistance to States for Capital Investment' aims at promoting capital expenditure at the sub-national level. Accordingly, the States' capital outlay-GDP ratio is budgeted to increase to 2.9 per cent in 2022-23 from 2.3 per cent in 2021-22 (PA). Similarly, the ratio of revenue expenditure to capital outlay (RECO) for the States is budgeted to improve to 5.2 in 2022-23 from 6.1 in 2021-22 (PA). The data available from the Comptroller and Auditor General of India (CAG), however, indicate that State governments' capital expenditure has grown at a modest rate of 7 per cent in H1:2022-23 as against 50 per cent growth recorded by the Centre. Hence, States need to step up investment in H2:2022-23 to meet their budgeted target for the year. Their efforts would be supported by buoyant tax and non-tax revenues, advance instalments of tax devolution from the Centre and front-loading of post-devolution revenue deficit grants.

1.5 Chapter II of this Report undertakes an in-depth analysis of the fiscal position of States in terms of actual outcome for 2020-21, revised estimates (RE) and provisional accounts (PA) for 2021-22, and budget estimates (BE) for 2022-23. The fiscal reforms initiated by the States in response to the Fifteenth Finance Commission's recommendations are evaluated in this Chapter. It also presents States' debt dynamics in terms of market borrowings, outstanding liabilities and guarantees.

1.6 Chapter III explores the theme of the Report. It analyses the direct and indirect channels through which States can promote investment. The linkages between capex, productivity and growth are probed. A composite index of the quality of expenditure is constructed to evaluate fiscal performance of States.

1.7 Chapter IV concludes by envisioning the way forward. Data on various budgetary components and fiscal indicators of all States and Union Territories with legislatures are presented in appendices and statements.