I Overview

1.1 In 2016-17, the finances of states were budgeted to improve at the consolidated level from the sharp deterioration in 2015-16 where the revised estimates (RE) of the gross fiscal deficit-gross domestic product (GFD-GDP) ratio breached the threshold of 3 per cent for the first time since 2004-05. The turnaround was premised on a surplus in the revenue account alongside a decline in loans and advances even as states planned for an increase in capital outlay so that fiscal consolidation is achieved through revenue augmentation rather than growth-inhibiting expenditure reduction. Key to the sustainability of this strategy over the medium term is the legislative approval of the Goods and Services Tax (GST) Act in September 2016 and its subsequent enactment into law with likely implementation from July 1, 2017. The GST is widely regarded as a critical structural reform with broader ramifications in terms of growth, inflation, fiscal viability and external competitiveness. Accordingly, this year's report adopts the GST as its theme[1].

1.2 Chapter II undertakes an in-depth analysis of the fiscal position of states. It draws attention to the worsening of the GFD-GDP ratio on account of the increase in capital outlay and loans and advances to power projects (around ₹990 billion were borrowed under UDAY by eight states during 2015-16). Although states projected for an improvement in the consolidated GFD-GDP ratio in 2016-17, information available for 25 states reveals a slippage of 0.4 per cent of GDP from budgeted estimates. States, however, are expected to continue their efforts towards fiscal consolidation. In fact, the consolidated GFD-GDP ratio of states is budgeted to improve in 2017-18. Implications for state level indebtedness is also addressed in this chapter. Finally, the chapter undertakes a detailed evaluation of debt sustainability at the state level which indicates that state governments are likely to remain solvent over the medium term.

1.3 Chapter III of the report provides a synoptic view of the design, mechanism and benefits of GST, drawing on the implementation of the VAT in India in 2005 and the lessons from the country experience. The Chapter evaluates the long term gains of implementing GST: (i) broadening the tax base by switching from an income-based to a consumption-based tax; (ii) reducing compliance cost; (iii) enhancing export competitiveness; (iv) promoting a conducive investment climate in the economy; and (v) triggering positive sentiments of foreign investors. It shows that these benefits are advantageous for higher growth over the medium term and significantly outweigh short-term costs in terms of the pass-through of GST to inflation [nearly 50 per cent of the consumer price index (CPI) is outside the ambit of GST]. On the fiscal front, tax buoyancy is expected to increase substantially reducing reliance on borrowings,

[1] All information on GST related policy developments are as of March 31, 2017.

improving debt servicing capacity and opening up greater space for fiscal consolidation.

1.4 Chapter IV explores some issues relating to GST: the revenue neutral rate; dispute resolution mechanism and IT infrastructure; and administrative control of GST. From a medium term perspective on state finances, this Chapter also addresses various issues relating to central transfers, implications of special levies and evolving fiscal federalism. In this context, it is pertinent to note that the likely implementation of the recommendations of the state pay commissions may enhance the committed expenditure burden on states, which may lead to greater recourse to additional borrowing. At the same time, greater devolution of resources to states through statutory transfers may increase the quantum of untied funds at the disposal of states in prioritising their developmental objectives.

1.5 Chapter V presents a synoptic view of the report with possible implications of recent policy developments on state finances in the years ahead. It cautions about the increase in future liabilities of states if they jump onto the "bandwagon" of farm loan waivers. In terms of general government finances, Centre's efforts to carry forward fiscal consolidation could be squandered unless state finances are shored up and strengthened. As of now, the budgeted consolidated GFD-GSDP ratio of 25 states at 2.6 per cent for 2017-18 is lower than the Central Government's budgeted GFD-GDP ratio of 3.2 per cent. In this context, the Fiscal Responsibility and Budget Management (FRBM) review Committee's recommendation for adopting the fiscal deficit as the key operational target consistent with achieving the combined government debt-GDP ratio of 60 per cent by financial year 2022-23 (FY 2023) assumes critical significance.

1.6 Data on various budgetary components and fiscal indicators of 29 states are presented in appendices and statements.