I Overview

1.1 Fiscal capacity - the total revenue that a government can realistically raise from the available tax and non-tax base – determines its ability to provide essential public goods and undertake capital spending for infrastructure and economic development while ensuring fiscal discipline and sustained macroeconomic stability (World Bank, 2009). Weak fiscal capacity can, in turn, force the economy into a middle-income trap[1] (World Bank 2015; ADBI 2017). The fiscal capacity of Indian States was dented by the COVID-19 pandemic in 2020-21. Given the key role of States in the provision of public services, a significant scaling up of their fiscal capacity from the pandemic-induced compression to levels commensurate with India's longer term developmental aspirations is critical. Accordingly, the theme of 'Revenue Dynamics and Fiscal Capacity of Indian States' has been chosen for this year's Report on 'State Finances: A Study of Budgets'.

1.2 For the States, primary sources of budgetary resources are own tax revenue, own non-tax revenue, tax devolution and grants from the Centre. Growth in own revenue receipts is widely used as an indicator of fiscal capacity, as it reflects the State government's ability to meet its expenditures on its own. Currently, the States finance only 58 per cent of their revenue expenditure from their own revenue sources. States with a relatively higher share of agriculture in gross state domestic product (GSDP) tend to have lower fiscal capacity; other factors like high per capita income, high education levels, low inflation, low corruption and lower size of the shadow economy also contribute to fiscal capacity (Davoodi and Grigorian, 2007; Fenochietto and Pessino, 2013; Garg *et. al.,* 2016). The goods and services tax (GST) collection capacity of States is determined by the scale of economic activity and the relative importance of non-agricultural sectors (Mukherjee, 2020).

1.3 Higher fiscal capacity itself does not guarantee sufficient revenue mobilisation, as tax effort – the efficiency with which revenues are collected – can differ significantly across States (Srivastava *et al.,* 2023). Tax effort also depends on non-economic factors, *viz.*, quality of institutions; administrative strength; and availability of infrastructure of tax departments (Bahl, 1972; Mukherjee, 2017).

1.4 Tax reforms, institutional reforms for better tax compliance, formalisation of the economy and greater use of technology in tax administration can potentially raise fiscal capacity. Own tax revenue to GSDP ratio of the States, which has stagnated around 6-7 per cent in the last decade, can be enhanced by the introduction of new taxes, rationalisation in the rates and bases of existing taxes, and improvement in tax administration and collection. Finance Commissions have sought to encourage States to increase their tax effort by devising formulae for tax sharing that reward States with superior tax effort. In direct tax collections, the States can raise more revenues through higher stamp duty and registration fees, as pointed out by the Fifteenth Finance Commission (FC -XV). Among indirect taxes, States Goods and Services Tax (SGST) collections which account

[1] The 'middle-income trap' refers to the phenomenon of rapidly growing low-income economies stagnating at middle-income levels and failing to graduate into the ranks of high-income countries.

for more than 40 per cent of own tax revenue, have improved in recent years. In this context, a reduction in the number of slabs, along with adjustments in rates, can improve efficiency and collection (Debroy, 2023).

1.5 There is also significant scope for mobilising resources through non-tax revenues, which have remained around 1 per cent of GDP in the last 10 years and pale in comparison to a ratio of 10 per cent or more in countries like Singapore, Egypt and Iran (IMF, 2006; Purohit and Purohit, 2009). The most important non-tax revenue sources are: (i) lease/sale of natural resources, like minerals; (ii) user charges on economic/social services provided by the government such as irrigation, electricity, health, education, forestry and wildlife; (iii) lotteries; and (iv) interest receipts from loans extended to entities like public sector undertakings (PSUs) and local bodies. Revising the existing charges and rates for various services provided by them, which are generally much lower than charges by the private sector, and revitalising and corporatising State PSUs can improve non-tax revenue performance of States (Pradhan, 2023).

1.6 Alongside, it is essential for States to foster business-friendly tax administration, improve ease of doing business in the spirit of cooperative federalism and avoid attempts to draw a territorial nexus with every transaction even though tax may have been paid in another State. This would go a long way in boosting taxpayer sentiments, increase compliance and thereby augment revenue for all States.

1.7 Chapter II of this Report undertakes an in-depth analysis of the fiscal position of States in terms of actual outcomes for 2021-22, revised estimates (RE) and provisional accounts (PA) for 2022-23, and budget estimates (BE) for 2023-24. The Chapter analyses the policy initiatives announced in State budgets for revenue augmentation, expenditure management and fiscal consolidation. It also presents a profile of their R&D expenditures, given their crucial role in promoting economic growth. Debt dynamics in terms of market borrowings, outstanding liabilities and guarantees are also discussed in the Chapter.

1.8 The theme of this year's report – revenue dynamics and fiscal capacity of Indian States - is covered in Chapter III. In this chapter, tax capacity and tax efforts of States are estimated using the stochastic frontier approach. The Chapter reviews States' current tax policies; examines volatility and buoyancy of their own tax revenue; and discusses issues relating to tax administration, tax compliance, coverage, and rate structure. It also analyses various aspects of non-tax revenues, including pricing of natural resources and socio-economic services, and return on investment of State PSUs with reference to international standards. In addition the Chapter reviews the structure of inter-governmental transfers in India and evaluates the implications of cess and surcharge imposed by the Centre for State finances.

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