

1.1 At the consolidated level, states budgeted for a turnaround in fiscal performance during 2015-16 from the deterioration that set in during the earlier two years. The projected improvement in key fiscal indicators was premised on cutbacks in revenue expenditure with a marginal decline in capital outlay. This pragmatic approach stems from the hard constraints faced in augmenting expenditure without eroding the modest gains in fiscal consolidation. Illustratively, the increase in states' share of tax devolution from 32 per cent to 42 per cent of the divisible pool on the recommendation by the fourteenth finance commission (FC-XIV) works out to a decline in consolidated state revenues from central transfers (share in central taxes *plus* grants in aid) by 0.3 per cent of GDP in 2015-16, due to discontinuation of many centrally sponsored schemes (CSS) announced in the Union Budget, 2015-16. In this milieu, the ability of states to maximise growth enhancing properties and efficiency gains embedded in targeted compositional shifts in expenditure patterns holds the key to optimising the contribution of sub-national fiscal policy to societal welfare. Accordingly, this year's report adopts the quality of expenditure as its theme. Empirical findings across a swathe of countries, advanced and emerging, confirm that the composition of government expenditure can have perceptible growth implications.

1.2 Chapter II of the report focusses on evaluating states' efforts to reap welfare gains from improvements in the composition of expenditure drawing on the evolution of ideas in the literature and the lessons from the country experience. It observes that expenditure quality at the sub-national level has improved under the impetus provided by implementation of fiscal responsibility and budget management (FRBM) rules, but there remains considerable scope for progress. In fact as the chapter underlines, this acquires urgency in the context of the imminent burden of salaries and pension liabilities of states associated with the demonstration effect of the seventh central pay commission (CPC-VII).

1.3 Chapter III undertakes an in-depth analysis of the fiscal position of states. It draws attentions to the rise in revenue and non-development expenditure and the consequent deterioration in the quality of states' spending. Implications for state level indebtedness from this sub-optimal prioritisation of expenditure are also addressed in this chapter.

1.4 Chapter IV explores some issues which are likely to have a bearing on the quality of states' expenditure in the medium-term; reform of state-level public enterprises, the goods and services tax and the Ujwal

Discoms Assurance Yojana (UDAY) scheme. It also discusses issues relating to the State Finance Commissions (SFCs).

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