4.1 States have budgeted prudently for 2019-20, but macroeconomic risks to their combined budget estimates appear to be slanted to the downside. The loss of momentum in economic activity needs to be reversed soon, otherwise it can have revenue implications for state budgets, if not complemented by extra efforts towards revenue mobilisation. If they do not materialise, cuts in expenditure to meet the fiscal targets may become inevitable. This can feed an ever-tightening vicious spiral of austerity deepening the economic downturn which, in turn, cramps fiscal revenues and forces further expenditure reductions and so on. In the case of states, there can be large macroeconomic spillovers from the spending retrenchments with states’ capital and developmental expenditure accounting for close to two-thirds of the combined expenditure. The negative output effects could exacerbate the medium-term challenge of debt sustainability, as highlighted in this Report.

4.2 States’ revenue prospects are confronted with low tax buoyancies, shrinking revenue autonomy under the GST framework and unpredictability associated with transfers of IGST and grants. Unrealistic revenue forecasts in budget estimates thereby leave no option for states than expenditure compression in even the most productive and employment-generating heads. Going forward, sustained efforts towards mobilising revenue need to be combined with strategies to maximise efficiency gains rather than increases in tax rates. In this context, the GST architecture has to be harnessed to achieve tax revenue growth target so as to gradually reduce the dependence on compensation cess. This involves expanding the tax base using IT infrastructure, data analytics and reduction in the cost of tax compliance.

4.3 The dedicated application of break-even user charges, with better cost recovery mechanisms offers scope for raising states’ revenue. In this vein, tariff policies relating to power and irrigation warrant a review. States need to learn from each other’s experience and develop indigenous strategies to enhance tax buoyancy and efficiency. As regards Central transfers, well-defined calendars; more effective expenditure planning and usage of funds; efficient cash management which reduces the negative carry; and marksmanship in budgetary forecasts assume importance. Re-prioritising Central transfers towards productive expenditures is essential in order to achieve equity with efficiency and sustainable levels of debt in the medium-term.

4.4 Off-budget liabilities in the form of guarantees a` la UDAY are mutating into a contingent risk to debt sustainability even as structural bottlenecks in power distribution continue to foster. Going forward, states
might have to take over higher losses of DISCOMs if they do not show a turnaround in their financial performance and this will inevitably take its toll on debt sustainability in the medium-term. Transparency in the disclosure/reporting of these liabilities in state budgets may be the first step towards recognising these guarantees as a medium-term fiscal risk, followed by conscious efforts to keep them at prudent levels while ensuring that they are not invoked.

4.5 Access to market financing via borrowings requires a pragmatic approach to ensure enduring sustainability. A combination of SDL consolidation, reissuances, maturity elongation and diversification of investor base should improve liquidity and minimise roll-over risk. Maintaining adequate Reserve Funds could help minimise fiscal stress arising from redemption pressures and unforeseen liabilities.

4.6 To conclude, states’ role in promoting growth and overall social welfare is critical as public policy responsibilities devolving on them are large. Yet, fiscal consolidation and pressures to increase current spending have led to an overall decline in capital spending to the tune of about 0.3 to 0.5 per cent of GDP during 2017-19. Arresting this trend is crucial to avoid adverse effects on long-term growth and welfare. Going forward, it is important for states to pursue their capital expenditure plans as budgeted in 2019-20 by front-loading them. This is particularly important as it has strong multiplier and welfare enhancing effects. The states will have to simultaneously make efforts towards improving their revenue raising capacity to support their expenditure. In the ultimate analysis, borrowed resources that are used wisely on projects/programmes with revenue and employment-generating potential will free up fiscal space and secure an optimal balance between growth and sustainability.