4.1 Last year’s Report on State Finances addressed the role of the States in the context of the regional dimension of the pandemic and the implications for healthcare infrastructure, digitisation and public finances. In 2021-22, the second wave of the pandemic has further scarred the fiscal positions of States. In contrast to the first wave, the response to the second wave was multi-pronged and decentralised, with a relatively greater incidence of responsibilities on the third-tier of government, namely, municipal corporations (MCs). This has inspired the choice of the theme of this year’s report – how this third-tier coped with the pandemic.

4.2 The first wave hit India at a time when majority of the States had already formulated their budgets for the year 2020-21. The severe economic consequences of the first wave took a grievous toll, especially during the first half of 2020-21. In the second half of the year however, with the fading away of infections and easing of restrictions, States could repair their finances on the back of a recovery in revenue collection and greater certainty on the GST compensation cess. In 2021-22 so far, revenue receipts of States have posted robust growth, led by their own tax revenue from State GST, excise duty and sales tax collections. Higher devolution and frontloading of GST compensation by the Centre have also provided a cushion.

4.3 In 2020-21, the shortfall in States’ revenue collections did not result into a concomitant fall in their capital outlay. This was mainly on account of the scheme of “Special Assistance to States for Capital Expenditure” announced by the Centre on October 12, 2020 as part of the Atma Nirbhar Bharat Abhiyan1 as well as reallocation and reprioritisation of expenditure by the States themselves. In 2021-22, State governments’ capital expenditure remains robust so far – the ratio of revenue spending to capital outlay (RECO) is budgeted to decline to 5.5 in 2021-22 from 6.7 in 2020-21.2 Within capital outlay, it is important for the States to channelise expenditure to sectors that crowd in private investments and optimise multiplier effects and inter-temporal and inter-sectoral linkages that boost output, employment and productivity.

4.4 As the impact of the second wave wanes, State governments need to take credible steps to address debt sustainability concerns. The combined debt to GDP ratio of States which stood at 31 per cent at end-March 2021 and is expected to remain at that level by end-March 2022, is worryingly higher than the target of 20 per cent to be achieved by 2022-233, as per the

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1 Under the scheme, financial assistance is provided to State governments in the form of 50-year interest free loan. An amount not exceeding ₹12,000 crore was earmarked for 2020-21 and an amount of ₹11,830.3 crore was released to the States in 2020-21. On April 29, 2021, the Centre announced the decision to provide an additional amount of upto ₹15,000 crore to States as interest-free 50-year loan for spending on capital projects. As of September 25, 2021, the Centre has approved capital projects of ₹2,903.8 crore in 8 States under the scheme entitled ‘Special Assistance to States for Capital Expenditure for 2021-22’. The Ministry has also released an amount of ₹1,393.8 crore to these States, viz., Bihar, Chhattisgarh, Himachal Pradesh, Madhya Pradesh, Maharashtra, Punjab, Sikkim and Telangana.

2 Capital expenditure undertaken by States accounts for more than 60 per cent of general government capital expenditure.

3 The N.K. Singh panel to review India’s existing Fiscal Responsibility and Budget Management (FRBM) rules (2017) has recommended a debt-to-GDP ratio of 40 per cent for the Central government and 20 per cent for the State governments together by the financial year 2022-23.
recommendations of the FRBM Review Committee (Chairman: N.K. Singh). In view of the pandemic induced slowdown, in its projections the FC-XV\(^4\) (Chairman: N. K. Singh) expects the debt-GDP ratio to peak at 33.3 per cent in 2022-23 (in view of the higher deficits in 2020-21, 2021-22 and 2022-23), and gradually decline thereafter to reach 32.5 per cent by 2025-26. The budgeted GFD of 3.7 per cent of GDP for States for the year 2021-22 - lower than the 4 per cent level as recommended by the FC-XV – reflect the State governments’ intent towards fiscal consolidation.

4.5 In 2021-22 so far (April-September, 2021), the gross and net market borrowings by State governments have been 13 per cent and 21 per cent lower than in the corresponding period of the previous year, respectively. States have preferred to borrow from financial accommodation provided by the RBI through short-term borrowing via the special drawing facility (SDF) and ways and means advances (WMA). Additionally, in recent years, the States have been accumulating sizeable cash surpluses in intermediate treasury bills (ITBs) and auction treasury bills (ATBs), although they involve a negative carry of interest rates for the States. This warrants improvements in cash management practices.

4.6 In the medium term, improvements in the fiscal position of State governments will be contingent upon reforms in the power sector as recommended by FC-XV and specified by the Centre\(^5\) - creating transparent and hassle-free provision of power subsidy to farmers; preventing leakages; and improving the health of the power distribution companies (DISCOMs) by alleviating their liquidity stress in a sustainable manner. Timely payments of State dues to DISCOMS and, in turn, by them to Generation Companies (GENCOS) hold the key to the sector’s financial health. Undertaking power sector reforms will not only facilitate additional borrowings of 0.25 per cent of GSDP by the States but also reduce their contingent liabilities due to improvement in financial health of the DISCOMs.

4.7 On the third-tier front, increasing the functional autonomy of the civic bodies, strengthening their governance structure and financially empowering them via higher resource availability through self-resource generation and transfers are critical for building resilience and effective interventions at the grass-root level. State governments should set up State Finance Commissions (SFC) at regular intervals, in line with the recommendations of FC XV. States may also urge rural and urban local bodies to make audited accounts available online in a timely manner to access grants. In addition, States should undertake local body reforms as stipulated by the Centre\(^6\) to improve the financial autonomy of third-tier governments.

4.8 Overall, sub-national fiscal positions are at an inflection point. Empowerment of the third-tier government presents an opportunity that can result in better and more effective pandemic crusaders in the future.

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\(^4\) The Report was presented to the Parliament on February 1, 2021.
