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DEMOCRACY AND PRUDENCE : THE STATE OF STATE FINANCES*

Interactive Session
3A

Chair: Michael Debabrata Patra

Speakers: Sudipto Mundle, Anoop Singh, R.Kavita Rao, Pravakar Sahoo, Ram Singh

Date: 04th October 2025 | Time: 11:30 - 13:00 hrs

Introduction

The fiscal position of Indian states has emerged as a critical determinant of the country's overall economic trajectory, given their pivotal role in delivering essential public services and driving development. States account for nearly two-thirds of general government expenditure, making their fiscal health central to macroeconomic stability, public investment, and the achievement of national development goals.

In recent years, growing fiscal pressures, rising committed expenditures, mounting debt levels, and misallocation of resources have constrained the ability of states to invest in social and economic infrastructure. At the same time, data gaps, inconsistencies in fiscal reporting, and off-budget liabilities have complicated the assessment of the true fiscal position of states.

Recognizing these challenges, the session on "Democracy and Prudence: The State of State Finances" brought together experts to deliberate on the evolving trends in state finances, transparency issues, fiscal health benchmarking, and the role of urban local bodies and property taxation in strengthening fiscal capacity. The discussions focused on both diagnostics and solutions, highlighting structural weaknesses as well as reform pathways for sustainable state-level public finance management.

Overview of State Finances and Expenditure Patterns

The session began by highlighting the misallocation of resources within state finances. A significant portion of state expenditure is directed toward loan waivers, welfare and social schemes, and freebies, which limits the fiscal space available for developmental spending. More than 50% of state expenditure is currently allocated to committed liabilities such as interest payments, salaries, and pensions, leaving limited resources for social and developmental functions.

This expenditure structure has led to the deterioration of state finances over time. The debt-to-GSDP ratio stood at 31% in 2020, decreased to 28%, and has now risen again to 31%, reflecting increasing fiscal pressures.

Bivariate Classification of States: Per Capita Income and Longevity

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A bivariate classification of states was presented based on per capita income and life expectancy. States such as Kerala, Maharashtra, and Tamil Nadu exhibit both higher per capita incomes and higher life expectancy, while states like Uttar Pradesh, Madhya Pradesh, and Rajasthan fall into the lower category on both parameters.

Fiscal Performance Indicators

The session then examined key fiscal performance indicators, including:

- Per capita income
- Capital expenditure to total expenditure ratio (CapEx/TotEx)
- Own revenue to total revenue ratio
- Fiscal deficit to GSDP ratio
- Debt to GSDP ratio

High-performing states such as Andhra Pradesh were noted. The need to improve the productivity of expenditures was underlined, with two-tier performance-linked conditional cash transfers (e.g., based on attendance or vaccination) cited as an example to enhance expenditure effectiveness.

Data Gaps and Transparency Challenges

A major theme was inconsistencies, misclassifications, and data gaps in state fiscal reporting.

Key issues include:

- Varying definitions of deficit and debt between the Centre and states.
- Abrupt changes in subsidy data components without explanations.
- Misclassification of maintenance cost grants as capital expenditures.
- Incomplete data across states and years.
- Exclusion of subsidy-equivalent schemes (e.g., special securities) from official statements.
- Off-budget borrowings through PSUs and SPVs often excluded from fiscal assessments.
- Non-uniform debt definitions and disclosure formats, leading to incomparability across states.
- Lack of separate disclosures for non-financial assets in capital spending.
- Insufficient granularity on borrowing modalities (e.g., public accounts, bonds, special banking arrangements).
- Implicit subsidies unreported, and capital spending not linked to specific projects.
- Delayed financial reporting, with accounts often not prepared within six months of year-end and CAG reports delayed beyond nine months.

These gaps are not merely technical but often intentional, underscoring that “Transparency is the politics of managing mistrust.”

Off-Budget Liabilities and Fiscal Underreporting

The issue of off-budget liabilities inflating actual debt was highlighted:

- In Andhra Pradesh, reported outstanding liabilities to GSDP are 32%, rising to 42% when off-budget borrowings are included.
- In Kerala, the ratio increases from 35% to 38% after adjustments.

Subsidy data is understated. For FY23, budgeted subsidies were 3.52% of revenue expenditure, while adjusted subsidies were 4.45%. Similarly, reported capital spending of 4.3% of GSDP was revised to 2.3%, indicating overstatements in official figures.

Recommendations for Harmonization and Fiscal Reform

The session offered several reform measures to address these issues:

- Harmonize fiscal definitions across levels of government.
- Standardize spending classifications in line with international standards.
- Integrate off-budget spending into fiscal accounts.
- Consolidate expenditures by SPVs, PSUs, and EBRs into composite capital expenditure figures with sectoral and project-specific details.
- Align fiscal data with the Government Finance Statistics Manual (GFSM).
- Reform the Public Financial Management (PFM) framework through Union–State collaboration.
- Strengthen state legislature accountability to their own Fiscal Responsibility Acts.
- Introduce a comprehensive PFM law covering both Union and states.

Recent Trends in State Finances

- Debt to GSDP fell from 30.1% (2020–21) to 25.1% (2023–24), with a modest increase to 25.8% expected in 2024–25 (RE).
- States with debt >30% fell from 19 to 14. High-debt states such as Bihar, Haryana, Punjab, Rajasthan, and Kerala have moderated.
- Fiscal deficit to GSDP averaged below 3% during 2021–22 to 2023–24, rising to 3.46% in 2024–25. States with fiscal deficits >3% rose from 12 to 18.
- Revenue deficit dropped from 48% of fiscal deficit in 2020–21 to 12% in 2023–24, rising slightly to 18% in 2024–25.
- Capital expenditure grew rapidly (over 20% between 2023–24 and 2024–25) and is projected to grow 15% in 2025–26 (BE). Fifteen states report average growth >20% during 2022–23 to 2025–26 (BE).
- Own-source revenues have strengthened post-COVID. Own tax revenue grew at 13% between 2022–23 and 2025–26 (BE); GST share in own tax revenue rose from 39.1% to 43.3%. The share of own revenue in total

revenue has also increased correspondingly.

Fiscal Health Index (NITI AAYOG)

The Fiscal Health Index launched by NITI AAYOG evaluates state fiscal performance based on five pillars:

1. Quality of expenditure – measured by the ratio of total development expenditure to total expenditure, and capital outlay to GSDP.
2. Revenue mobilization – state's own revenue to GSDP and to total expenditure.
3. Fiscal prudence – gross fiscal deficit to GSDP and revenue deficit to GSDP.
4. Debt index – interest payments to revenue receipts and outstanding liabilities to GSDP.
5. Debt sustainability – GSDP growth rate vs. interest payment growth.

Over the last decade, the debt index has declined, interest payments have increased, and quality of expenditure has deteriorated, necessitating the creation of benchmarks.

Top performers in the index: Odisha (1), Chhattisgarh, Goa.

Bottom performers: West Bengal, Andhra Pradesh, Punjab (18).

Classification:

- Achievers: Odisha, Chhattisgarh, Goa, Jharkhand, Gujarat – high capital outlay (~4% of GSDP), effective non-tax revenue mobilization, revenue surpluses, low interest payments (~7% of revenue receipts).
- Frontrunners: Maharashtra, Uttar Pradesh, Telangana, Madhya Pradesh, Karnataka – high development expenditure (~73%), balanced fiscal accounts, improved debt sustainability (~24% debt to GSDP).
- Performers: Tamil Nadu, Rajasthan, Bihar, Haryana – developmental expenditure ~70%, low revenue share, rising debt, interest payouts 16–20% of revenue receipts.
- Aspirational: Kerala, West Bengal, Andhra Pradesh, Punjab – fiscal and revenue deficit slippages, low revenue mobilization, rising debt, sustainability concerns.

Property Tax and Urban Local Bodies (ULBs)

The session then turned to ULBs and property taxation, emphasizing their critical role in fiscal health:

- Budgets of ULBs equal 1.3% of India's GDP, while own revenue is only 0.6%.
- Weak ULB finances stem from low capital expenditure and pressure to reduce devolutions.
- Property tax is key to fixing this fiscal gap, as emphasized by the 15th Finance Commission.

Urban India faces inadequate infrastructure, underutilized productivity, and overlapping jurisdictions. GST has worsened ULB finances by reducing compensation flows. Property tax can boost steady revenue streams, enabling municipal bonds (including sustainability and parametric bonds) to finance infrastructure.

Current property tax collection in India is 0.2% of GDP, far below OECD averages (1.08%) and countries like Canada (3.05%), the US (2.47%), and the UK (3.11%). Property tax constitutes ~16% of municipal revenue.

Potential:

- At a 0.5% tax rate, ULBs could raise 0.5% of GDP; at 1%, they could raise 1% of GDP.
- European and US property tax rates are typically 0.5–1% of market value; East Asia (China, Philippines) 1–2%.

The Indian property paradox was discussed: high property values and rents coexist with very low property tax collections, due to rent control, valuation gaps, and exemptions. This undermines ULB fiscal autonomy and competitiveness.

Supply-Side Measures

To strengthen fiscal capacity and urban revenue systems, the session suggested supply-side measures:

- Rationalize lower Land Use Ratios (LURs) and reduce Floor Area Ratios (FARs) to reflect market realities.
- Monetize land hoarded by public sector entities.
- Adopt an integrated approach to infrastructure investment.
- Implement higher FARs near transport lines to encourage density.
- Introduce higher property tax rates in prime locations to reflect economic value.

Conclusion

The session underscored that states are the cornerstone of India's development, accounting for two-thirds of general government spending. Strengthening state finances through transparent reporting, harmonized definitions, sound fiscal management, and robust local revenue systems is essential for fiscal sustainability and growth.

Monitoring fiscal health, improving expenditure quality, mobilizing revenues effectively, and empowering ULBs through property taxation are key steps toward fiscal prudence. Transparency and harmonization are not just technical measures-they are essential tools for managing mistrust and ensuring accountable public finance.

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