

INCREMENTAL REFORMS BY STATES IN POWER AND LOCAL BODIES COULD POTENTIALLY ADD AT LEAST RS 72000 CRORE TO STATES KITTY IN FY22

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In May'20, as part of the Aatmanirbhar Bharat package, the Government of India had increased the States' borrowing limit from 3% to 5% of GSDP, for FY21 only. Out of this 0.5% was unconditional for all, 1% was made conditional on the implementation of four economic reforms and 0.5% was available as reward for implementing 3 reforms out of the stipulated 4 reforms. Overall, 23 states availed of additional borrowings of Rs 1.06 lakh crore out of a potential of Rs 2.14 lakh crore. In FY22, based on the 15th Finance Commission's recommendation, the Centre has allowed states a net market borrowing of up to 4% of GSDP, additional 0.5% of GDP conditional borrowing on fulfilment of power sector reforms. Given that in FY21 only 13 states have undertaken power sector reforms, if other states follow suit in FY22, the states still can borrow Rs 1.1 lakh crore from RBI.

The Government has accepted the 15th finance commission recommendations for devolution of central taxes at 41% for FY22-FY26, compared to 42% by the 14th finance commission. However, one major change is the increase in share of grants in total transfers to states to 19.65% from 11.97% by the 14th FC. The total transfer is at Rs 50.78 lakh crore (Rs 42.25 lakh crore as tax devolution and Rs 8.53 lakh crore as grants). For the local bodies grant, a total of Rs 4.36 lakh crore was recommended by the FC for FY22-FY26.

However, the FC has recommended certain pre-conditions that must be satisfied by the local bodies to receive grants. One of the major conditions is having both provisional and audited accounts online in the public domain by the local bodies. Apart from these entry level conditions, there are certain other conditions related to the usage which are prescribed by FC.

Specifically, for FY22, the total accepted statutory transfer to states amounts to Rs 8.8 lakh crore (Rs 6.6 lakh crore as tax devolution and Rs 2.2 lakh crore as grants) or 3.9% of projected GDP. Within grants, only Rs 1.54 lakh crore is unconditional and the remaining Rs 67,105 crore for local bodies is conditional.

Such large proportion given to local bodies (51% of the total accepted grants) and health grant (16% of overall allotment to local bodies) for local bodies are huge positive developments and will certainly help in improving the primary health conditions and basic conditions of water and sanitation in rural areas.

Coming to revenues, the GST collection after posting above Rs 1 lakh crore mark for eight months in a row, dropped down to Rs 92,849 crore in June'21, as the intensity of COVID-19 second wave was severely felt on business transactions made in May'21. However, with reduction in caseload and easing of lockdowns it is expected that the revenues will see an increase again from July'21 onwards. For the 29 states, our estimates (based on average monthly collections till now) suggest that the total revenue including cess would be Rs 7.59 lakh crore (cess: Rs 1.03 lakh crore), while they have budgeted Rs 7.98 lakh crore, thus indicating a shortfall of Rs 0.40 lakh crore for the states. State GST could still surprise as there is a potential upside, notwithstanding the dip in June.

Coming again to states, there could however be a shortfall of Rs 0.53 lakh—Rs 0.65 lakh crore for states from oil excise at the current rate and consumption trends as per PPAC.

Summing up, Indian states face a potential revenue shortfall of around Rs 1.05 lakh crore in FY22 budget estimates. However, if the states could carry out the reforms in power sector and the local bodies, a potential amount of Rs 1.77 lakh crores could still be available to them. This implies that Indian states could still end FY22 with an additional Rs 72,000 thousand crore in their kitty. Thus, fiscal position of Indian states is still much better than the overall consensus.

Also, the recently released overall tax collection numbers have provided much cheer for the Centre. For example, for Centre the gains from GST would be still Rs 58,930 crore as per current trends. More interestingly, if we take the official Government projections of petrol and diesel consumption for FY22 that are available in public domain, the Centre could potentially add at least Rs 1.10 –1.32 lakh crore over the budgeted excise numbers. For FY21, the Centre had realised Rs 94,000 crore over the budgeted numbers from oil excise. Thus at an aggregate basis, the Centre does have a much better fiscal position currently with an estimated Rs 1.7 lakh crore tax revenue upside from budgeted numbers. Even if we assume that Centre could face potential headwinds for its disinvestment collections, the fiscal numbers provide a sense of comfort for any additional fiscal lever in future.

CONDITIONAL REFORMS OF STATES

- ◆ In May'20, as part of the Aatmanirbhar Bharat package, the Government of India had increased the States' borrowing limits from 3% to 5% of GSDP, for FY21 only. Out of this 0.5% was unconditional for all, 1% was made conditional on the implementation of 4 economic reforms and 0.5% was available as reward for implementing only 3 reforms.
- ◆ This nudge for reform is rare in Indian public finance and incentivizes the states to adopt progressive policies to avail additional funds. The results of this exercise are not only encouraging but also run contrary to the notion that there are limited takers for sound economic policies. Overall, 23 states availed of additional borrowings of Rs 1.06 lakh crores out of a potential of Rs 2.14 lakh crores. As a result, the aggregate borrowing permission granted to states for 2020-21 (conditional and unconditional) was 4.5% of the initially estimated GSDP.
- ◆ In FY22, based on 15th Finance Commission's recommendations, the Centre has allowed states a net market borrowing of up to 4% of GSDP, additional 0.5% of GSDP conditional borrowing on fulfilment of power sector reforms.
- ◆ Ministry of Power has set 3 reforms in the sector: (i) reduction in Aggregate Technical & Commercial (AT&C) losses; (ii) achieve the targeted reduction in Average Cost of Supply and Average Revenue Realisation (ACS-ARR) gap and (iii) DBT to Farmers on free power supply. These reforms also aim at improving the health of the distribution companies (DISCOMs) sustainably by providing them liquidity.
- ◆ Despite the pandemic, the aggregate state government borrowing during April to 06 July stands at Rs 1.59 lakh crore, which is 11.5% less compared to last year borrowings of Rs 1.80 lakh crore in the corresponding period. In FY21, only 13 states have undertaken power sector reforms, so we believe other states will do the power sector reforms to avail extra borrowing from RBI. **We estimate that states could borrow an additional Rs 1.1 lakh crore if they undertake the desired power sector reforms in FY22.**

GREATER FOCUS ON CONDITIONAL TRANSFERS BY FC

The author is thankful to Prof. Indira Rajaraman for her insights on the 15th finance commission report.

- ◆ The 15th finance commission recommended states share in central taxes to be 41% for FY22-FY226, compared to 42% by the 14th finance commission. The 1% adjustment is on account of new UTs of Jammu & Kashmir and Ladakh. The Commission recommended an increase in total transfers by 17% to Rs 52.57 lakh crore from Rs 44.85 lakh crore by the 14th FC. Though actual value of tax devolution amount has increased, but as % of GDP its share has declined to 3.15% compared to 4.11% of GDP in 14th FC.

Additional State Borrowings through Reforms

Stipulated Reforms	No. of States	Amount Borrowed
1. Implementation of One Nation One Ration Card	17	37600
2. Improving ease of doing business	20	39521
3. Urban Local body/ utility reforms	11	15957
4. Power Sector reforms	13	13201
Total Additional Borrowing by States in FY21		1,06,279

Source: SBI Research

State Borrowings Till 06 July

States	FY22	FY21
Andhra Pradesh	16000	17000
Arunachal Pradesh	400	428
Assam	500	1000
Bihar	6000	0
Chhattisgarh	1000	0
Goa	400	700
Gujarat	5500	9280
Haryana	10000	9000
Himachal Pradesh	0	0
Jammu and Kashmir	2600	2500
Jharkhand	0	0
Karnataka	0	7000
Kerala	9000	12430
Madhya Pradesh	0	6000
Maharashtra	26500	25500
Manipur	400	450
Meghalaya	400	200
Mizoram	250	310
Nagaland	600	350
Odisha	0	3000
Punjab	4700	5450
Rajasthan	17500	17000
Sikkim	500	467
Tamil Nadu	26000	30500
Telangana	13500	14461
Tripura	0	0
UT of Puducherry	0	0
Uttar Pradesh	5000	6000
Uttarakhand	700	1000
West Bengal	12000	10000
Total	159450	180026
Gross Borrowing FY22	10,97,143	7,98,816
%	14.5%	22.5%

- ◆ There has been an increase in the share of grants in total transfers to 19.65% from 11.97% by the 14th FC. The 15th FC also recommended additional borrowing room to states based on performance in power sector reforms. This time not all the grants recommended by the FC have been accepted by the Action Taken Report (ATR) of the Government. The Government has stated that due consideration will be given to those sectors identified by the Commission while formulating and implementing existing and new Centrally Sponsored and Central Sector Schemes. The total **accepted transfer is Rs 50.78 lakh crore (Rs 42.25 lakh crore as tax devolution and Rs 8.53 lakh crore as grants).**
- ◆ The revenue deficit grants amounting to Rs 2.94 lakh crore for seventeen States over 2021-22 to 2025-26 have been accepted by the Government. For the local bodies grant a total of Rs 4.36 lakh crore is recommended by the FC for FY22-FY26. Of this a sum of Rs 2.36 lakh crore is earmarked for rural local bodies, Rs 1.21 lakh crore for urban local bodies.
- ◆ Another Rs 70,051 crore is for health grants (unconditional) through local governments for physical infrastructure and diagnostic facilities at local level. Furthermore, Rs 8,000 crore is performance-based grants for incubation of new cities and Rs 450 crore is for shared municipal services.
- ◆ However, the FC has clearly recommended certain pre-conditions that must be satisfied by the local bodies to receive grants. These include (i) setting up of State Finance Commissions in States, act upon their recommendations and lay the explanatory memorandum as to the action taken thereon before the State legislature on or before March 2024 (ii) having both provisional and audited accounts online in the public domain (iii) fixation of minimum floor for property tax rates by the relevant State followed by consistent improvement in the collection of property taxes in tandem with the growth rate of State's own GSDP (for urban local bodies).
- ◆ Apart from these entry level conditions, **there are certain other conditions related to the usage which are prescribed by FC.**
- ◆ The Commission recommended that 60% of the grants to rural local bodies and for urban local bodies in non-Million-Plus cities should be tied to supporting and strengthening the delivery of two categories of basic services: (a) **sanitation**, maintenance of ODF status (for Rural Local Bodies), solid waste management and attainment of star ratings as developed by MoHUA (for non-million plus cities/ Category-II Cities/ Towns);

Total Grants & Incentives (Rs crore)		
S.no	Heads	FY22-FY26
1	Revenue deficit	294514
2	Local government grants	436361
3	Disaster mangement grants	122601
4	Sector-specific grants	129987
	Sectoral grants for Health	31755
	School Education	4800
	Higher Education	6143
	Implementation of Agricultural Reforms	45000
	Maintenance of PMGSY roads	27539
	Judiciary	10425
	Statistics	1175
	Aspirational districts & blocks	3150
5	State-specific grants	49599
6	Total reccomended by 15th FC	1033062
7	Total accepted by ATF (6-4-5)	853476

- ◆ (b) **drinking water**, rain water harvesting and water recycling (both for Rural Local Bodies and Urban Local Bodies). Furthermore, **for cities with million plus population (Million-Plus cities), 100% of the grants are performance-linked** through the Million-Plus Cities Challenge Fund (MCF). All these have been accepted by the Government.
- ◆ The large proportion given to local bodies (51% of the total accepted grants) and health grant (16% of overall allotment to local bodies) for local bodies are huge positive developments and will certainly help in improving the primary health conditions and basic conditions of water and sanitation in rural areas.
- ◆ For the disaster management a sum of Rs 1.6 lakh crore has been recommended for FY22-26 of which the Centre's share is Rs 1.2 lakh crore and States' share is Rs 37,552 crore. This has been accepted by the Government in full.

CONDITIONAL TRANSFERS TO STATES IN FY22 AT RS 67,105 CRORE

- ◆ For FY22, the Government has accepted total grants of Rs 2.2 lakh crore. Of this, amount of Rs 80,297 crore is for local Government bodies out of which Rs 13,192 crore which is for primary health services is unconditional, however the remaining amount of Rs 67,105 crore is conditional.

- ◆ All the entry level conditions for local bodies exist for FY22 as well, except that at least 25% of the local bodies should have both provisional and audited accounts online in the public domain. Even the usage conditionality for spending on water and sanitation exists for FY22.

GST REVENUE SCENARIO LOOKS HEALTHY DESPITE DROP IN JUNE

- ◆ The GST collection after posting above ₹1 lakh crore mark for eight months in a row, dropped down to ₹92,849 crore in June'21, as the intensity of COVID-19 second wave was severely felt on business transactions made in May'21. However, with reduction in caseload and easing of lockdowns it is expected the revenues will see an increase again from July'21 onwards.
- ◆ If we look at the Q1 data, the CGST totalled Rs 61853 crore with a monthly average of Rs 20618 crore. The overall CGST for the entire fiscal will be Rs 2.48 lakh crore, displaying a y-o-y growth of 18% over FY21 and 8% over FY19. Meanwhile, quarterly SGST collections were Rs 78761 crore, with monthly average of Rs 26224 crore. Thus, estimating SGST collection at this rate leads to Rs 31.5 lakh crore with y-o-y growth of 15% over FY21 and 2% over FY19, which leads us to believe that our SGST estimate is conservative. The same exercise conducted for IGST and Cess collections yields yearly figures of Rs 6.83 lakh crore and Rs 1.03 lakh crore respectively.
- ◆ The FY22 growth rates over FY21 and FY20 stand at 21% and 16% for IGST and 18% and 14% for Cess. The combined GST growth rate would be 19% over FY21 and 11% over FY20.
- ◆ For the 29 states, the total revenue including cess would be Rs 7.59 crore (cess: Rs 1.03 lakh crore), while they have budgeted Rs 7.98 crore, thus indicating a shortfall of Rs 39486 crore. However, as mentioned above, State GST could surprise as there is a potential upside, notwithstanding the dip in June. Meanwhile, for Centre the gains would be Rs 58930 crore, as it has budgeted Rs 5.3 lakh crore while the revenue estimate stands at Rs 5.89 lakh crore.
- ◆ Overall, tax revenue as % of GDP is a fairly stable indicator, with the % swaying very little over the years for various sub-components, even though GST revenue trend is difficult to quantify as it is a recent tax. However, going by the data for 2020 and 2021, we have Centre's GST revenue at around 2.3% of GDP. The Rs 5.89 lakh crore collection translates to 2.3% of GDP at 15% nominal GDP growth rate. Hence, we are confident of Government achieving this target.

Grants for FY22 (Rs crore)	
Revenue deficit	118452
Local government grants	80297
A. Rural local bodies	44901
B. Urban Local bodies	22114
C. Health	13192
Shared municipal services	90
Disaster management grants	22184
Total Grants	220933
Conditional Grants (A+B)	67015

FY22 Tax revenue through GST(Rs crore)	
FY22 GST(1+2+3+4)	1347768
1.CGST	247412
2.SGST	314684
3.IGST	683036
4.Cess	102636
5.States' IGST Share@50%	341518
6.Centre's IGST Share@50%	341518
7.States' GST revenue excl cess(2+5)	656202
8.States' GST revenue incl cess(7+4)	758838
9.States' estimates BE(SGST+Cess)*	798324
10.Difference in revenue estimates for States(8-9)	-39486
11.Centre's GST Revenue excl cess(1+6)	588930
12.Centre's GST revenue BE excl cess	530000
13.Difference in revenue estimates for Centre(11-12)	58930

ADDITIONAL OIL REVENUE FROM EXCISE TO TOP RS 1 LAKH CRORE IN FY22

- ◆ If we look at the other major revenue component, the taxes levied on petrol and diesel again Centre will comfortably meet its budgeted revenue under this head.
- ◆ The official PPAC projections show 12.2% and 15.1% growth of petrol and diesel consumption for FY22. Also, the PPAC data shows Centre's excise taxes on the unbranded category of these products at Rs 32.9 and Rs 31.8 per litre. Multiplying these with the projected consumption shows total revenue of Rs 4.67 lakh core, while Centre has budgeted only Rs 3.35 lakh crore. So there is gain of Rs 1.32 lakh crore at the current excise rate structure.

- ◆ For states our estimates based on an average \$74 /bbl crude oil basket and Rupee dollar exchange at Rs 75 show that states would be garnering Rs 2.71 lakh crore under sales tax/ state VAT on petrol and diesel. The states have budgeted Rs 3.55 crore as Sales Tax/ State VAT and these include some other products as well. As per the FY20 actual data, 91% of the total Sales Tax/ VAT came from POL Products.
- ◆ If we reduce the diesel consumption to 7%, the gains for Centre come at Rs 4.45 lakh crore, while for states the shortfall is Rs 0.65 lakh crore.
- ◆ So, it is expected that if the tax rates continue at this level then states will display the same trend in State VAT/ Sales tax target as last year.
- ◆ It may be noted that Centre does not have to share the extra revenue raked in through Excise as out of the Rs 32.9 per litre tax revenue on petrol, only Rs 1.4 is part of the divisible pool. The rest is in the form of Special Additional Excise Duty, Agriculture Infrastructure & Development Cess (AIDC) and Additional Excise Duty (Road and infrastructure Cess). The case is similar for diesel.
- ◆ Thus, for every 1 litre increase in consumption of petrol, out of Rs 32.9 Rs 32.3 goes to Centre and 59 paise is devolved to states.
- ◆ Additionally, states also gain from their own duties. At present the average VAT is around Rs 20/litre for petrol and Rs 15/litre for diesel.

Tax revenue through Petrol and Diesel (Rs crore)			
	FY22		FY21 RE Gain over FY21 BE
	At the prevailing Central Excise Duty (PPAC Estimates of Consumption)	At the prevailing Central Excise Duty (SBI Estimates of Consumption)	
States:			
1.States' estimated Sales Tax/VAT Revenue from Petrol and Diesel	270582	258621	-50625
2. States' BE(State VAT/Sales Tax), contribution of POL products@91%	323348	323348	
3..Difference in revenue estimates for States(1-2)	-52766	-64727	
Centre:			
4.Centre projected Revenue from from Petrol and Diesel	467514	444941	94000
5.Centre BE(Excise)	335000	335000	
6.Difference in revenue estimates for Centre(5-6)	132514	109941	
Source: SBI Research			

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