

State Finances

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RBI highlights states' role in capital formation

- The RBI's recent report on state finances echoes many of our views, reiterating our belief that the role of states is crucial for capital formation in India. It also shows concern around lagging state capex, which is up by only 3% YoY vs 38% budgeted growth. Even with the expected pick-up in spending in Q4, we expect the total state capex to undershoot the BE by ~10%.
- This is due to states' desire for fiscal consolidation; we expect the state GFD/GDP to come in at 2.8% in FY23 vs the budgeted 3.4%, due to increased revenue and the drop in capex.
- Borrowing is also down as a result (-2% YoY FYTD), and far lower than the indicative borrowing for the year. FY23 gross borrowing is expected to modestly increase to INR7.5trn.
- This puts states in a sweet spot, but the RBI is clear that in order to take advantage of this, states need to build fiscal buffers and step up capex, rather than considering it as a residual.
- The report also emphasizes the importance of human capital development through increased capex on education and healthcare, so, it is encouraging that the share of these sectors in the total state capex is at an all-time high in the FY23BE.

States remain crucial to capital formation in India, but are lagging...

The RBI report on state finances, released this Monday, highlights the role of states in capital formation in India. It also echoes our concerns on how states, which were once leading public capex, are now lagging. Budgeted capex growth for FY23 (over FY22RE) is at 38%, but as of November, our assessment of 26 states suggests their capex has grown by only 3% YoY. Historically, states tend to undershoot their budgeted capex by a wide margin (by 20% of BE, on an average over the last seven years); but this undershoot is only around 7-10% for revex, which is mostly committed in nature (salaries, pensions, subsidies and so on). Another concern that the RBI highlighted, in line with our recent write-up (*'Fiscal Position: The struggle of state finances'*), is that states' capex spending is typically heavily skewed towards the last quarter of the fiscal year, with nearly a quarter of the year's total spending taking place in March alone. This suggests that capital expenditure is being treated as a residual by states. Nevertheless, if this trend were to continue this year too, it is extremely unlikely that states would meet their budgeted capex target of INR6.9trn (for the 26 states surveyed), even with the expected pick-up in spending in Q4FY23.

...due to their focus on fiscal consolidation

The reason for states' reticence on increased capex despite timely payment of GST compensation from the Centre, along with the release of two advance instalments of tax devolution and the Centre's INR1.0trn special assistance scheme for capex, is also well-known: fiscal consolidation. The gross fiscal deficit (GFD) for states rose to 4.1% of GDP in FY21 due to the pandemic, and states have been on the path to improvement since then. The GFD/GDP came down to 2.8% in FY22, with higher growth in both, tax and non-tax, revenues helping bolster state finances; the trend seems to have continued; the FY23BE is at 3.4%, but going by states' borrowings, revenue flow and lower capex, their revised GFD/GDP is likely to be far lower (at around 2.8%).

Fiscal prudence leads to a drop in borrowings

Fiscal consolidation has also extended to state debt, with gross borrowing down by ~2% as against the same period last year (April-December). We note that states have been borrowing far less than the indicative calendar thus far (30% lower as of December), and even though the indicative calendar for Q4 suggests that they will borrow INR3.41trn in this period, the actual borrowing will be lower, as seen in the three auctions so far in January, where states have borrowed only INR262bn against an indicative number of INR534bn (51% lower). We expect gross state borrowing of INR7.5trn (vs the budgeted INR8.5trn), and net borrowing of INR5.1trn (vs the budgeted INR6.1trn). While this is a welcome development as far as fiscal responsibility is concerned, the RBI's report makes it clear that "states need to take advantage of this sweet spot (of increased revenue and lower borrowing) by building up fiscal buffers and stepping up capex". The overall situation of state borrowing does warrant some concern on a medium to long-term basis though, given that states that are spending the most as a % of their GDP are also having the highest outstanding liabilities.

Human capital development and physical infrastructure are crucial for growth

The RBI report also highlights the importance of spending on education and health for human capital formation, so it is a welcome sign that the share of education and health in the total state capex as per the FY23BE was the highest ever. Differences in economic growth among Indian states has been found to be related to differences in spending on health and education, as well as the creation of physical infrastructure that promotes growth, making it critical that these areas remain in focus for capex, going forward as well. States should consider building capex buffer funds during periods of strong revenue to maintain expenditure through downturns.

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Key Highlights

- State capex is up only 3% YoY; expected to undershoot the FY23BE by ~10%
- State GFD/GDP likely to be at 2.8% vs FY23BE of 3.4%
- Gross borrowing to modestly increase to INR7.5trn

Exhibit 1: Fiscal position of states

Fiscal summary of 31 states and UTs						Growth %				
INR tn	2020	2021	2022RE	2022P	2023BE	2021/ 2020	2022RE/ 2021	2022P/ 2021	2022P/ 2022RE	2023BE/ 2022RE
Revenue receipts	26.7	25.9	33.5	32.2	38.6	-3.1	29.6	24.6	-3.8	15.0
Tax revenue	18.8	17.7	22.6	23.6	26.2	-5.8	28.0	33.3	4.2	15.7
Non-tax revenue	2.6	1.8	2.6	2.5	3.2	-32.6	46.6	39.2	-5.0	25.6
Grants from Centre	5.4	6.4	8.3	6.2	9.2	20.4	29.5	-3.3	-25.3	10.0
Non-debt capital receipts	0.6	0.2	0.3	0.2	0.2	-59.6	17.4	-4.3	-18.5	-25.9
Recovery of loans and advances	0.6	0.1	0.2	0.2	0.1	-77.2	53.8	61.5	5.0	-30.0
Other receipts	0.0	0.1	0.1	0.0	0.1		-30.0	-90.0	-85.7	-14.3
Revenue Expenditure	27.9	29.6	35.7	33.3	39.4	5.9	20.7	12.4	-6.8	10.4
Interest Payments	3.5	3.9	4.3	4.1	4.7	10.3	12.1	7.0	-4.6	8.5
Capital Expenditure	4.6	4.6	6.9	5.9	8.2	-0.7	51.9	28.9	-15.1	18.0
Capital Outlay	4.2	4.1	6.3	5.5	7.5	-1.0	53.1	31.6	-14.0	18.9
Loans and Advances	0.4	0.4	0.6	0.4	0.7	2.4	39.5	2.3	-26.7	8.3
Deficit indicators										
Revenue Deficit	1.2	3.7	2.2	1.0	0.8					
Gross Fiscal Deficit	5.3	8.1	8.8	6.7	8.8					
Primary Deficit	1.7	4.2	4.5	2.5	4.1					
RD/GDP (%)	0.6	1.9	0.9	0.4	0.3					
GFD/GDP (%)	2.6	4.1	3.7	2.8	3.4					
PD/GDP (%)	0.9	2.1	1.9	1.1	1.6					

Source: RBI, Emkay Research

Exhibit 2: States' revenue growth remains robust, but capex continues to lag

INR bn	FYTD23	FYTD22	YoY growth so far	Budgeted growth	Required growth for remainder	FY23 BE	FY23 % of BE	FY22 BE	FY22 % of BE
Total Receipts	20,044	17,035	18	14	10	34,019	59%	29,741	57%
Revenue Receipts	20,001	16,344	22	15	5	33,878	59%	29,526	55%
Tax Revenue	15,449	12,156	27	15	(2)	23,887	65%	20,791	58%
Non Tax Revenue	1,433	1,180	21	30	38	2,996	48%	2,312	51%
Non-debt capital receipts	44	691	(94)	(34)	(120)	141	31%	215	322%
Total expenditure	22,215	20,112	10	13	16	42,122	53%	37,264	54%
Revenue Expenditure	19,713	17,672	12	11	11	35,321	56%	31,732	56%
Capital Expenditure	2,502	2,440	3	23	44	6,947	36%	5,532	44%
Revenue Surplus/Deficit	54	(1,328)	(104)			(1,444)	-4%	(1,283)	104%
Fiscal Surplus/Deficit	(2,720)	(3,911)	(30)			(8,103)	34%	(7,028)	56%

*Data for 26 states

Source: CAG, State budget documents, Emkay Research

Exhibit 3: Healthy growth across almost all tax categories

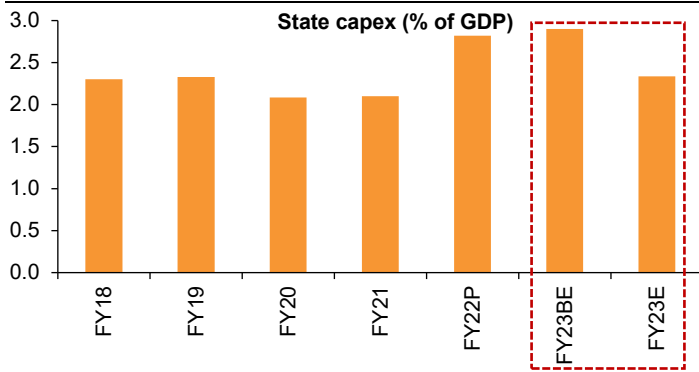
INR bn	FYTD23	FYTD22	YoY (%)
Tax Revenue	15,449	12,156	27
SGST	5,048	3,924	29
Stamps and Registration Fees	1,199	956	25
Land Revenue	97	77	25
Sales Tax	2,501	2,664	(6)
State Excise	1,405	1,167	20
State's Share of Union Taxes	4,273	3,198	34
Other Taxes	924	666	39

Source: CAG, Emkay Research

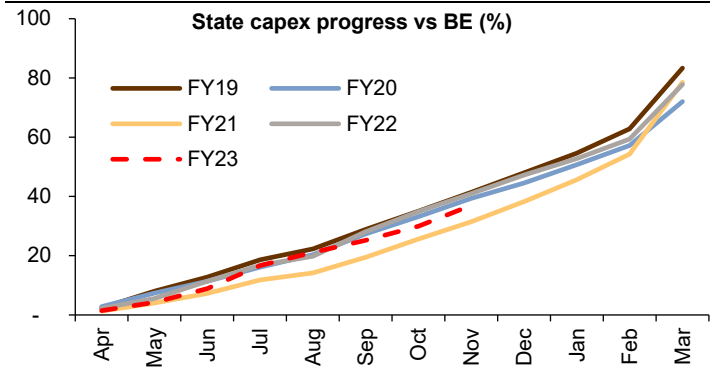
Exhibit 4: Pension, subsidies and interest payments drive revex growth

INR bn	FYTD23	FYTD22	YoY (%)
Revenue Expenditure	19,713	17,672	12
Int Payments	2,303	2,061	12
Salaries and Wages	4,369	4,376	(0)
Pension	2,758	2,431	13
Subsidy	1,281	1,165	10

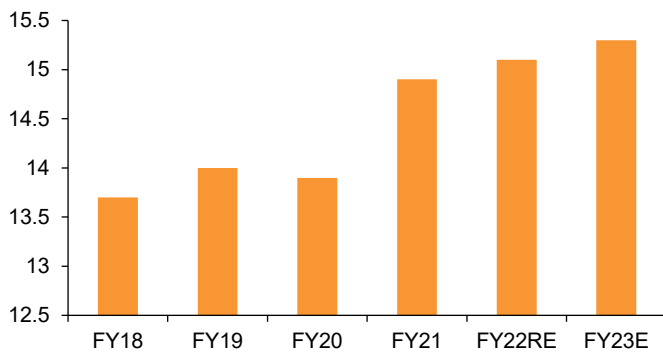
Source: CAG, Emkay Research

Exhibit 5: State capex is set to decline as a % of GDP, despite the strong budgeted growth...

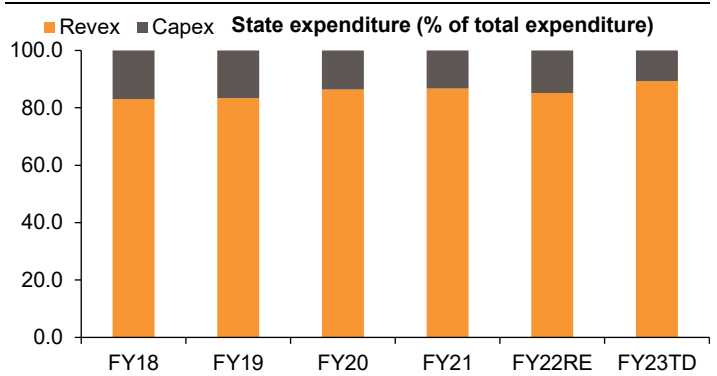
Source: RBI, State budget documents, Emkay Research estimates

Exhibit 6: ...and is likely to be ~10% below FY23BE, even after the expected pick-up in spending in Q4

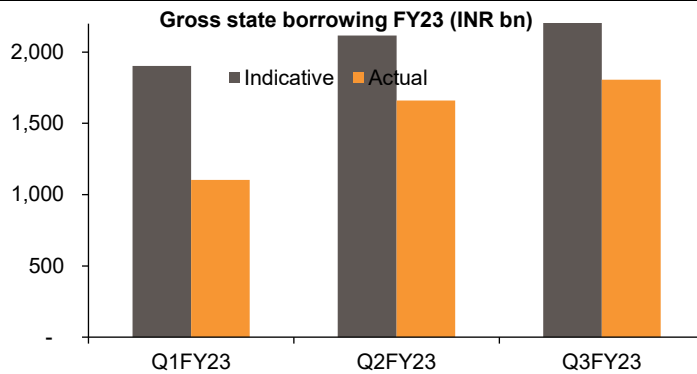
Source: State budget documents, CAG, Emkay Research estimates

Exhibit 7: Revex is set to increase as a % of GDP...

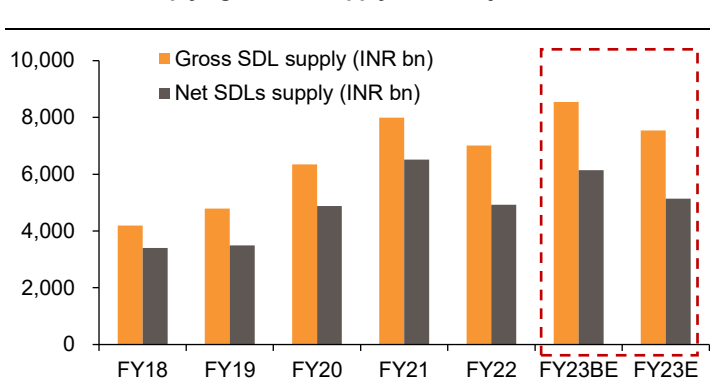
Source: RBI, Emkay Research estimates

Exhibit 8: ...and is also higher as a share of total expenditure so far

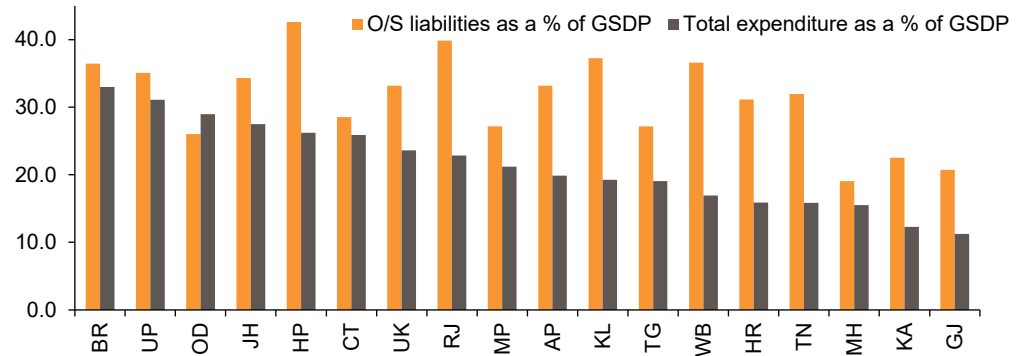
Source: State budget documents, CAG, Emkay Research estimates

Exhibit 9: State borrowing has been much lower than the indicative...

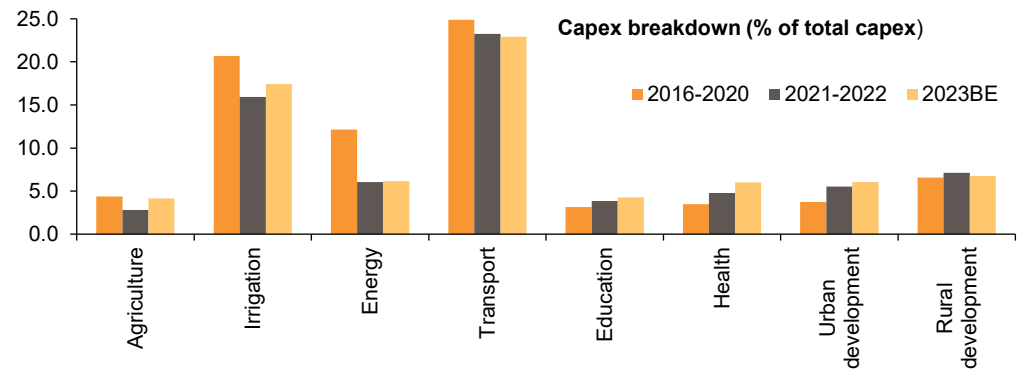
Source: RBI, Emkay Research estimates

Exhibit 10: ...implying that net supply could be just above INR5trn

Source: RBI, CAG, Emkay Research estimates

Exhibit 11: States with the highest outstanding liabilities are among those with the highest spend

Source: RBI, CAG, Emkay Research

Exhibit 12: Capex is moving higher for agri, irrigation, health, education and urban development

Source: RBI, State budget documents, Emkay Research; Note: Numbers for 2022 are based on Revised Estimates

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