I Overview

The adoption of Fiscal Responsibility Legislations (FRLs) by State governments along with other tax and expenditure reforms fostered overall fiscal sustainability at the subnational level. These reforms can be reinforced with "next generation" fiscal rules; the use of data analytics, including machine learning and artificial intelligence; improved data transparency and disclosure practices; and strengthening the institution of State Finance Commissions to deliver public services more effectively and scale up social and physical infrastructure.

1.1 The adoption of the Fiscal Responsibility Legislations (FRLs) by the State governments in the early 2000s contributed to an improvement in their key fiscal parameters. The consolidated gross fiscal deficit (GFD) of the Indian States fell from an average of 4.3 per cent of GDP during the period 1998-99 to 2003-04 to 2.7 per cent of GDP during 2004-05 to 2023-24. Concomitantly, the overall debt of the States declined from 31.8 per cent of GDP at end-March 2004 to 28.5 per cent of GDP at end-March 2024; however, it remains well above the level of 20 per cent recommended by the Fiscal Responsibility and Budget Management (FRBM) Review Committee (2017). Moreover, large inter-state variation persists, and new pressures are emerging from an increasing subsidy burden. These developments underline the need for deepening fiscal consolidation by the States. Accordingly, this year's *State Finances* Report adopts 'Fiscal Reforms by States' as its theme. It undertakes a comprehensive assessment of fiscal reforms carried out by the State governments over the last two decades and suggests next generation reforms in alignment with the evolving economic and geopolitical environment.

1.2 After the implementation of FRLs, fiscal reforms by States have mainly aimed at simplification of taxes and prioritisation of expenditure on focused areas at its core. The most noteworthy taxation reform in the post-FRL era has been the introduction of the goods and services tax (GST) which addressed issues such as multiplicity and cascading effect of indirect taxation (Bansal, 2023). The prominent expenditure reforms include, *inter alia,* shift from the Old Pension Scheme (OPS) to the National Pension System (NPS)[1]; move towards Direct Benefit Transfers (DBT); and implementation of a Single Nodal Agency (SNA) for the centrally sponsored schemes. Borrowing reforms have led to a greater reliance on market-based financing, with the share of market borrowings in financing of GFD increasing from 17.0 per cent in 2005-06 to 79.0 per cent in 2024-25 (BE). The Reserve Bank

[1] The Union Cabinet on August 24, 2024, approved the Unified Pension Scheme (UPS), providing an assured pension of 50 per cent of the average basic pay drawn over last 12 months. The other features of UPS include a family pension, a minimum pension after 10 years of service, inflation indexation, and a lump sum payment at superannuation without reducing the pension quantum. The UPS framework is available for adoption by State governments.

of India, as the debt manager, has streamlined the borrowing and cash management practices of States.

1.3 Rapid changes in the economic and geopolitical environment warrant further refinements in States' fiscal frameworks. First, "next generation" fiscal rules which combine the medium-term fiscal sustainability objective with short-term flexibility allowing State governments more maneuverability in dealing with exogenous economic shocks could be considered. This would require strengthening of institutions and improvements in fiscal reporting while incorporating the implications of evolving challenges, especially climate change and population aging (IMF, 2022).

1.4 Second, data analytics, adoption of machine learning and artificial intelligence can help States further refine their taxation systems and augment tax capacity (Govindharaj, 2023; RBI, 2023). States can also increase non-tax revenue by timely revisions of user charges, particularly for power, water and transport services (RBI, 2023).

1.5 Third, further rationalisation of the number of centrally sponsored schemes (CSS) can make room for undertaking more productive expenditure. Adherence to the 'golden rule'[2] of public finance would ensure that capital expenditure is not compromised while States adhere to FRL targets. An urgent review of the outgoes on subsidies is warranted to free up resources for increased investment in health, education, agriculture, research and development (R&D) and rural infrastructure, which will help create more jobs and reduce poverty on a sustainable basis (Gulati, 2022).

1.6 Fourth, greater focus on fiscal transparency and disclosure practices would help States to achieve lower deficits and debt ratios (Arbatli and Escolano, 2015). State governments could reap credibility benefits from enhanced and timely disclosures of significant changes in accounting standards; pension liabilities worked out on an actuarial basis; better information on supplementary demand for grants and its end uses; and updated records of contingent liabilities.

1.7 Fifth, next generation fiscal reforms at the sub-national level must also focus on improving fiscal data generation and dissemination processes. In particular, quarterly data release is hampered by non-availability in the case of a few States/UTs and delays in others. In addition, compilation and reporting of State governments' expenditure on climate budgeting, research and development (R&D) spending and transfers to urban and rural local bodies has assumed importance over time. Such data would help to design more appropriate policies.

1.8 Sixth, electricity distribution companies (DISCOMs) continue to remain a drag on State finances, with total accumulated losses at ₹6.5 lakh crore[3] by 2022-23 (2.4 per cent of GDP) (Power Finance Corporation, 2024). Initiatives aimed at enhancing productivity, reducing transmission and distribution losses, rationalising tariffs in accordance with the underlying cost of power supply, unbundling the electricity supply industry, and privatising generation and distribution remain

[2] The 'golden rule' requires that all current/revenue expenditures should be financed from current revenue and capital expenditure should be financed through borrowings (Rao, 2018).

[3] Six States are contributing to 75 per cent of the total national losses *viz.*, Tamil Nadu, Rajasthan, Uttar Pradesh, Madhya Pradesh, Telangana and Maharashtra.