Representation to the Sixteenth Finance Commission

A Plea for Inclusive and Sustainable Growth

Discussion Paper

2024

Prepared by

Foundation for Democratic Reforms

FDR FOUNDATION for DEMOCRATIC REFORMS

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&	And
C&AG	Comptroller and Auditor General
CAGR	Compound Annual Growth Rate
CBO	Congressional Budget Office
CSS	Centrally Sponsored Schemes
DISCOM	Distribution Company
FC	Finance Commission
FD	Financial Deficit
FRBM	Fiscal Responsibility and Budget Management
FY	Financial Year
GDP	Gross Domestic Product
GSDP	Gross State Domestic Product
ISW	Individual Short-Term Welfare
MDM	Mid-Day Meal
NPS	National Pension Scheme
OASDI	Old Age, Survivor, and Disability Insurance
OBR	Office for Budget Responsibility

OECD	Organisation for Economic Co-operation and Development
OPS	Old Pension Scheme
OROP	One Rank One Pension
p., Pg.	Page
PBO	Parliamentary Budget Office
PDS	Public Distribution System
PRC	Pay Revision Commission
SPVs	Special Purpose Vehicles
U.S.A.	United States of America
UK	United Kingdom
UPS	Unified Pension Scheme

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Executive Summary

India stands at a critical juncture in its economic journey, facing a narrow window of opportunity to achieve sustained economic growth and improve the lives of its people. The country has made notable strides – the astute fiscal management practised by the Union, improvement in infrastructure, combined with a conducive climate for investment and growth – has positioned India on a promising growth path. However, India's growth trajectory is now in jeopardy of being derailed if timely steps are not taken to mitigate risks.

India, like many other countries, is nearing a demographic tipping point. With the fertility rate already at replacement level, India is quickly approaching the point where the old-age dependency ratio (number of persons over 60 years to number in 15–59 age group) is going to turn increasingly adverse. This shift underscores the urgency of capitalising on the country's demographic dividend while it still exists. Beyond India's internal challenges, it is important to consider global growth limitations on account of slowing of population growth, and the unlikelihood of another technological revolution with the transformative impact of the 20th century. As opportunities for such breakthroughs become more limited, growth rates in the 21st century may not match those of the earlier century. Therefore, in the face of potential global headwinds, India needs to enhance productivity and harness our growth potential to the fullest extent in order to sustain high growth rates.

Sustaining high economic growth must, therefore, be the highest priority for the government. Unfortunately, India's political landscape remains divided on this issue, with a fundamental clash of ideas. On one side is the imperative for prudent economic management and the creation of market conditions conducive

to higher growth. On the other, there is a growing demand for redistributive policies at the expense of fiscal prudence and capital investment. While the short-term individual welfare may resonate politically, especially in a poor democracy, it is economically unsound and perilous for the country's prosperity if long-term collective goods and services are neglected.

Addressing these challenges requires a clear, coordinated approach. The path forward must be guided by a framework that integrates fiscal discipline, effective governance, and inclusive growth. This paper presents a three-part framework to address these pressing concerns. The first section delves into the need for a viable fiscal framework to protect India's long-term economic prospects. It calls for a fine balance between short-term individual welfare measures and long-term growth-promoting expenditures, urging the Union and the States to exercise fiscal prudence and embrace a shared responsibility towards intergenerational equity. The second section focuses on fiscal federalism, where the devolution of resources to local governments, the third tier of federalism, needs to be substantially increased in a predictable manner. Our weakest link of governance lies in the local governments which are largely emasculated and underfunded. Devolution must aim to generate maximal outcomes by ensuring predictable and accountable systems that enhance the capacity of local governments to deliver effectively. The third and final section highlights the critical role of small-town development in fostering inclusive growth. By nurturing small towns as magnets for the vast, unorganised, low-skilled workforce, we can create sustainable economic opportunities for the bulk of the rural poor though in-situ urbanisation.

In a democracy with a large economically disadvantaged population – 80–90% of the workforce is in the unorganised sector[1] eking out a precarious livelihood; 65% of the population resides in rural areas[2] with limited opportunities; 42% depend on agriculture as their primary source of livelihood[3] – pursuing growth strategies that are both effective and popular becomes critical. Voters may fail to connect their votes with long-term benefits, making them more susceptible to populist promises that risk derailing growth and perpetuating poverty and inequality. This makes inclusive growth essential to enable people to understand and appreciate the tangible improvements in their lives so that pro-growth policies are electorally viable. In any case, inclusive growth by definition enhances the productivity of the poor and marginalised sections, and helps them come out of poverty and pursue a path of prosperity with confidence and dignity. Ensuring that resources are utilised effectively today lays the foundation for growth that benefits all, making it crucial to address fiscal management and interconnected challenges. Only with fiscal discipline and broad consensus on growth can India secure its long-term prosperity and ensure that the benefits of growth are widely shared.

[1] *Certain sources cite the number to be higher than 90%. However, taking the discrepancies owing to the gig economy and unidentified self-employed workforce in the country, a rough estimate of 80%-90% is quoted.*

[2] Ministry of Finance, Government of India. (2023). Economic Survey 2022-23.

[3] Ministry of Finance, Government of India. (2023). Economic Survey 2022-23.

1. Ensuring Long-Term Fiscal Stability for Sustained Growth

India's fiscal federalism has evolved significantly over the years, with the Union increasingly devolving substantial resources to the States. This shift has granted States greater autonomy in their spending decisions, particularly after the abolition of the Planning Commission. It is estimated that in FY 2024-25, ₹12,47,211 crore (₹12.47 trillion) is transferred to States through devolution, while an additional ₹10,30,132 crore (₹10.30 trillion) allocated via various transfers, including Centrally Sponsored Schemes (CSS) aligned with national priorities, and local government grants. Together, this amounts to a substantial transfer of ₹22,77,343 crore (₹22.77 trillion) to the States (Annexure 1), or 55.6% of the gross revenues of the Union.

A crucial point often missed in the debate on fiscal federalism in India is the sheer scale of this resource transfer. After these allocations, the Union government retains a net revenue of approximately ₹18,19,394 crore (₹18.19 trillion; Annexure 1) which accounts for ~37% of the general government expenditure (Annexure 2). About 63% of general government expenditure (including local government expenditure) occurs at the State level (Annexure 2), underscoring the pivotal role States play in delivering essential services to citizens. Table 2 (General Government Expenditure in Select Countries) on Pg. 53 gives details of federal and State level expenditures in large economies. As can be seen, in India the States spend a lion's share of the general government expenditure. In fact, the States' share of expenditure is highest in India whereas local governments account for a paltry share.

This financial structure and the wide range of responsibilities allocated to the States under the Constitution have enhanced the political clout of States, positioning them as key actors in governance and fiscal policy. However, this enhanced autonomy has also placed significant responsibility on States to manage their finances effectively. Despite receiving substantial transfers, the fiscal health of many States remains precarious. Poor fiscal management, combined with unsustainable spending practices, has created a 'legacy problem' for several States, with rising debt and deficits threatening their ability to meet their obligations.

At the same time, the Union government faces its own fiscal constraints. Large transfers to States, combined with committed expenditure obligations such as salaries, pensions, and interest payments, have left the Union starved of resources. After accounting for these transfers and obligations, the Union is saddled with a structural deficit of ₹1,25,609 crore (₹1.25 trillion), leaving little to no fiscal room (Annexure 1). This dual strain on both the Union and the State finances highlights their mutual interdependence in preserving fiscal health across the tiers of government. The expenditure patterns and debt burdens of both the Union and the States play a critical role in determining the overall sustainability of public finances, the viability of public expenditure, and the ability of governments to fulfil their basic obligations to taxpayers.

1.1. Unsustainable Debt and Spending Practices

Over time, several States have accumulated substantial debts due to rising current spending, divided into discretionary and non-discretionary expenditures. Discretionary spending, comprise unchecked Individual Short-Term Welfare (ISW) measures, holds political appeal but lacks a legal mandate, making it subject to

shifting priorities and economic conditions. Balancing ISW programs with growth-oriented expenditures is essential to maintain fiscal health and preserve long-term economic growth.

Non-discretionary expenditures, comprising salaries, pensions, and interest payments, pose a fixed and rising burden on revenues. These fixed obligations consume a significant portion of States' own revenues, leaving limited fiscal space for other priorities. This has led many States to resort to borrowing for current expenditures, further compounding the fiscal stress. Indicators such as persistent high revenue deficits, the disproportionate share of States' own revenues spent on committed expenditures, mounting debt-to-GSDP ratios, and the rising cost of servicing public debt highlight the severity of the problem.

As a result, judicious capital spending – critical for driving long-term growth and development – has suffered significantly. The disproportionate outflow of resources for current expenditure limits the ability of States to invest in critical infrastructure and other growth-oriented sectors, further deepening fiscal vulnerabilities.

Further exacerbating this issue, many States are using Special Purpose Vehicles (SPVs) to create unfunded and unaccounted future liabilities that do not appear in current budgets. These SPVs borrow with government guarantees, sometimes using future government revenues that flow directly into escrow accounts for debt repayment. These SPVs are non-commercial entities and have no revenue streams of their own. While the immediate fiscal strain of these borrowings may be concealed, the liability of servicing these debts is borne by the exchequer. As these obligations accumulate, they pose significant fiscal challenges in subsequent years, further constraining State finances.

Worryingly, there are reports of Scheduled Commercial Banks, including Public Sector Banks, refusing to disclose their lending to State governments even to the Comptroller and Auditor General (C&AG). Several reports suggest that the actual liabilities of State governments may be much higher than reported due to repeated deferrals and postponements of bills, which could amount to tens of thousands of crores. These include payments to contractors, public procurement expenditure, and deferred allowances to employees, among others. Off-budget borrowings and unpaid bills add to fiscal burden and are essentially mechanisms to circumvent Fiscal Responsibility and Budget Management (FRBM) norms. Deferring these obligations only postpones the financial burden, making fiscal management even more challenging in future years.

Box 1: Fiscal Stress in Andhra Pradesh: An Alarming Picture of Debt and Deficits

In the State of Andhra Pradesh, the severity of the fiscal burden is especially evident, as highlighted in the recent White Paper released by the State government. In FY 2024-25, the State's outstanding liabilities, as reflected in the Budget (including Public Account), are estimated at 34% of the Gross

Table I: Outstanding Liabilities, Andhra Pradesh (2024-25)

Heads	Amount in ₹ crore
Government Debt (Including Public Account Liabilities)	5,60,094
Corporation Debt	2,48,677
Outstanding Dues to Vendor & Schemes	1,13,244
Outstanding Dues to Employees	21,980
Non contribution to Sinking Fund	1,196
Total	**9,45,191**
GSDP of Andhra Pradesh	16,41,624
Outstanding Liabilities as a share of GSDP	**57.58%**

Source:
1. Finance Department, Government of Andhra Pradesh. (2024, July). White paper on State Finances.
GSDP of Andhra Pradesh
2. PRS Legislative Research. (2024, November). Andhra Pradesh budget analysis: 2024-25.

State Domestic Product (GSDP). However, this figure significantly understates the full extent of the State's fiscal burden.

When off-budget borrowings by corporations and Special Purpose Vehicles (SPVs), which ultimately have to be repaid by the State, are included, the outstanding liabilities escalate to 49% of the GSDP. These corporations or SPVs, often reliant on future government revenues pledged through escrow accounts, lack independent revenue streams, making the State responsible for servicing their debts. In fact, the Comptroller and Auditor General's report clearly states that the State government has already been providing grants to these SPVs or corporations specifically for debt servicing. Furthermore, if the arrears owed to vendors and employees – obligations that must eventually be cleared by the government– are factored in, the total outstanding liabilities surge to a staggering 57% of the GSDP.

Table II: Resource Gap, Andhra Pradesh

Heads	Amount in ₹ crore
State Own Revenues	96,270
Tax Devolution	49,365
Central Assistance to State Plan	18,000
Capital Receipts (Public Debt)	75,505
Total Receipts	**2,39,140**
Salaries & Pensions	92,869
Debt Servicing (including corporations)	71,881
Welfare Pensions	33,600
Power Subsidy	14,000
PDS Subsidy	5,000
Arogyasri, Diet, MDM, Anganwadi	6,074
Central Assistance to State Plan	24,000
Administration Expenses	3,400
Essential Expenditure	**2,50,824**
Resource Gap	11,684
Outstanding Dues	1,35,224
Total Resource Gap	**1,46,908**
Revenue Deficit	**1,32,264**
Revenue Deficit as a share of GSDP	**8%**

GSDP: Gross State Domestic Product

Note:
1. Revenue Deficit is calculated assuming that outstanding dues are paid over a period of 3 years.

Source:
1. Finance Department, Government of Andhra Pradesh. (2024, July). White paper on State Finances.

This level of debt clearly signals unsustainability and imposes an immediate and overwhelming strain on the State's fiscal capacity. In FY 2024-25, Interest payments alone account for 60% of the State's own revenue. When other components of committed expenditures, such as salaries and pensions, are included, they account for an alarming 82% of the total revenue. Consequently, the State's revenue deficit balloons to 8% of the GSDP. As such a high revenue deficit cannot be fully met by the borrowings (given the FRBM norms), there will be indefinite deferral of unpaid bills, and the State will eventually be forced to curtail current expenditure through drastic measures. This precarious fiscal situation is unsustainable and needs urgent attention.

Source:
1. Finance Department, Government of Andhra Pradesh. (2024, July). White paper on State Finances.

1.1.1. Inter-State Variations in Fiscal Management

The fiscal health of States across India reveals significant disparities in the adherence to norms of fiscal prudence (Figures 1A and 1B). Broadly, States can be categorised into three distinct groups based on their fiscal practices and performance. States with a debt-GSDP ratio exceeding 40%, coupled with committed expenditure (salaries, pensions, and interest payments) as a share of their own revenues above 100%, clearly face significant fiscal challenges. These States are often unable to balance their budgets effectively, as a disproportionate share of their revenues is consumed by salaries, pensions, and interest payments over which they have no control or discretion, leaving little room for growth-oriented investments. The second category of States are those that are managing their finances prudently – with a debt-to-GSDP ratio of around 20% and committed expenditure around 60–70% of own revenues – may be considered

fiscally sound. There is, however, a third category of States falling in between; while economically strong, they show signs of fiscal mismanagement. These States exhibit high debt levels and committed expenditures relative to their economic size, raising concerns about fiscal practices.

Fiscal experts can develop refined, objective criteria to assess the financial standing of each State, helping to identify early signs of stress and steps needed to mitigate long-term vulnerabilities. Given the significant variations in fiscal health across States, it is essential to evaluate each State individually, ensuring that the unique challenges of each State are not overlooked by broader trends. Continuous monitoring of fiscal stress points will be crucial in safeguarding against potential risks and maintaining fiscal stability in the long run.

1.1.1.1. States with High Debt and Fiscal Stress

States like Punjab, Rajasthan, West Bengal, and Andhra Pradesh are characterised by high debt-to-GSDP ratios and excessive committed expenditure obligations as a share of their own revenues. These States allocate a disproportionate portion of their revenues to salaries, pensions, and interest payments, leaving limited fiscal space for growth-oriented investments. In the case of Andhra Pradesh, significant deferred liabilities exacerbate fiscal stress. These States are at the forefront of fiscal vulnerability, with borrowing mostly directed toward meeting current expenditures instead of creating productive assets.

1.1.1.2. States Exercising Fiscal Discipline

In contrast, States like Gujarat, Odisha, Maharashtra, and Karnataka exemplify fiscal prudence. These States maintain low debt-to-GSDP ratios and allocate a

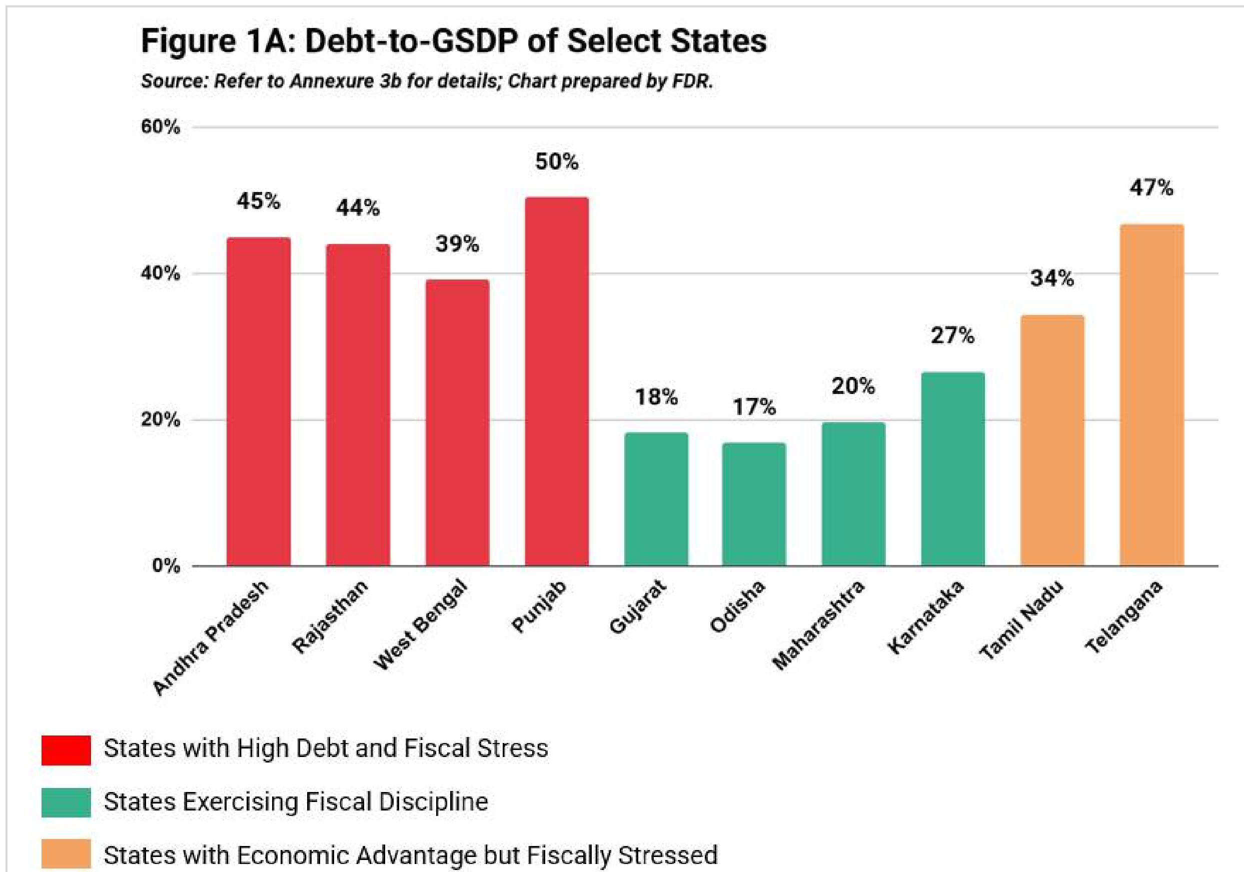
smaller proportion of their own revenues to committed expenditures. Odisha, in particular, stands out as a State with relatively low per capita income but exceptional fiscal discipline. With a debt-to-GSDP ratio of 17% (Figure 1A), Odisha manages to sustain a healthy fiscal balance while investing significantly in growth-oriented sectors. This demonstrates that strong fiscal management is possible even in the face of developmental challenges.

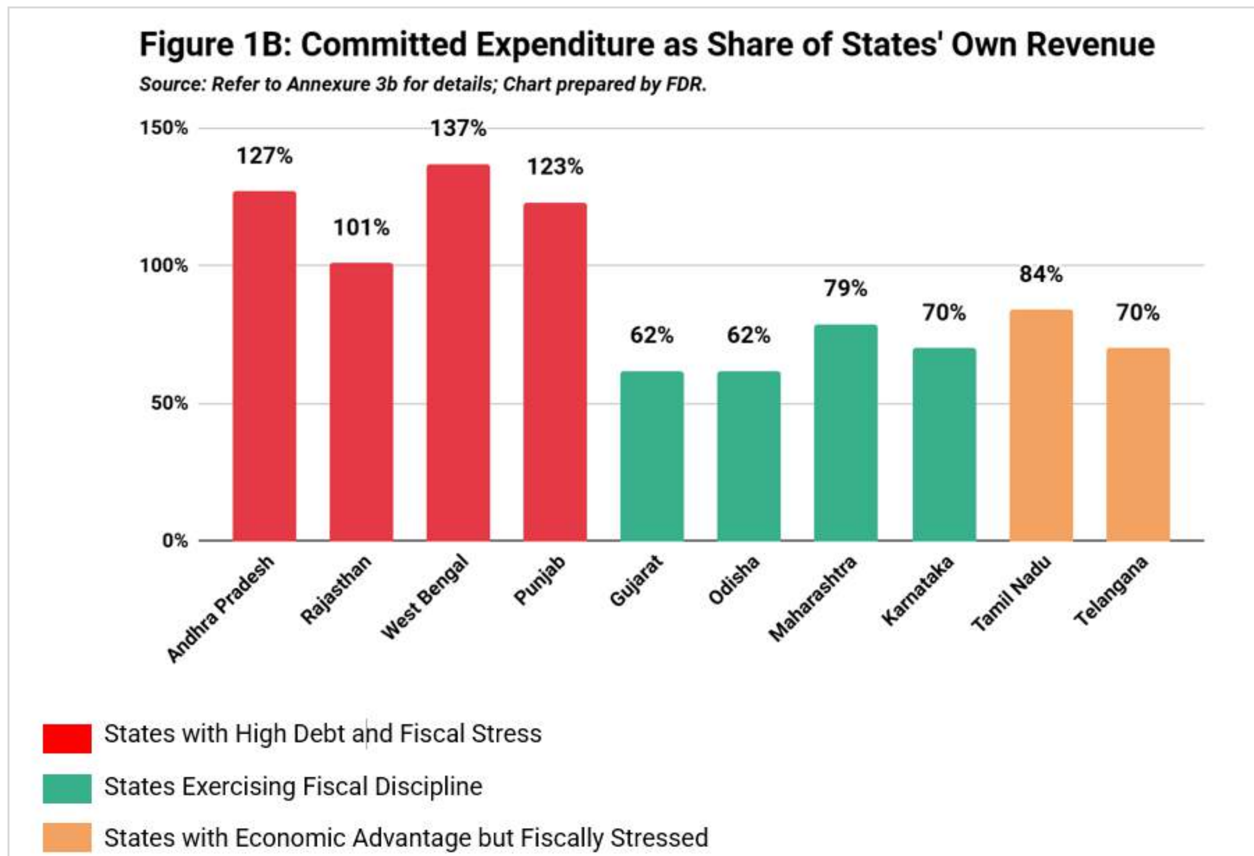
1.1.1.3. States with Economic Advantage but Fiscally Stressed

Tamil Nadu and Telangana represent States with significant economic advantages but face fiscal challenges due to profligate spending. Both States have large, economically vibrant cities – Chennai and Hyderabad – as engines of growth. Tamil Nadu, despite being highly urbanised and industrialised with a strong metropolitan growth engine, is burdened by unproductive expenditures like ISWs and underperforming DISCOMs.

Similarly, Telangana benefits from the booming economy of a metropolis and a relatively smaller rural population, which should ideally translate to stronger fiscal outcomes. However, fiscal indiscipline – marked by large ISWs, inflated government wages, and high-cost capital projects with limited returns – continues to create fiscal stress. The State initially started with one of the highest revenue surpluses, and subsequently slipped into a revenue deficit. While the State has now managed to record a revenue surplus, its debt-to-GSDP ratio remains very high at 47% (Figure 1A), reflecting significant fiscal vulnerabilities. The long-term burden of maintaining unviable capital projects and very high spending on ISW measures pose ongoing risks to fiscal sustainability. Although the State's economic advantages may shield it from immediate collapse, its poor

fiscal practices leave it vulnerable to deeper financial challenges in the future.



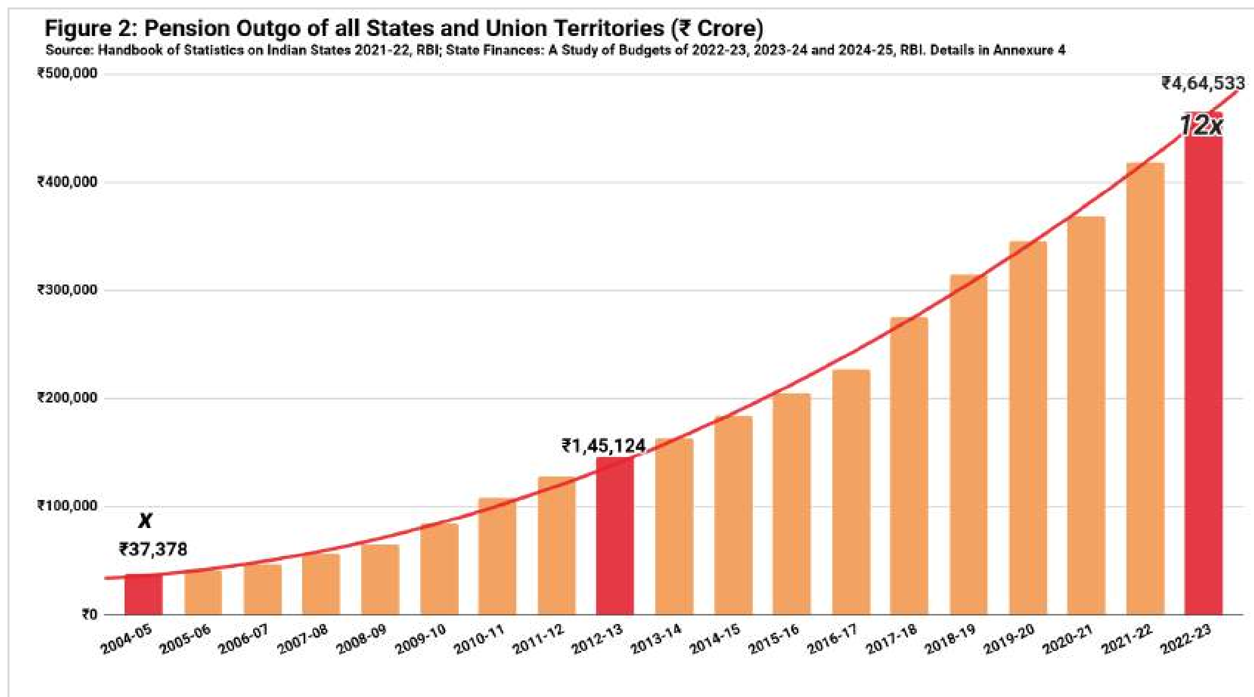


This stark contrast between the three distinct groups underscores that fiscal prudence can coexist with growth and development. States with limited economic resources, such as Odisha, have shown that disciplined financial management, prioritisation of growth-oriented investments, and effective resource allocation can lead to sustainable finances despite developmental challenges. On the other hand, the cases of Tamil Nadu and Telangana highlight that even economically advanced States must adhere to sound fiscal principles to avoid fiscal stress. These examples demonstrate that political stability, electoral viability, and sound public finances are not mutually exclusive – they can thrive together with political commitment to fiscal discipline and long-term growth.

1.1.2. Challenges with Pension Schemes

The recent reversal of policy in five States – Punjab, Rajasthan, Chhattisgarh, Jharkhand, and Himachal Pradesh – to switch from the defined contribution-based National Pension System (NPS) to the unfunded, index-linked, defined benefit-based old pension scheme (OPS), along with West Bengal's which persisted with the unviable OPS, will spell disaster for public finances in the long run. OPS creates substantial liabilities that disproportionately favour a small segment of the population while imposing unsustainable financial burdens on future generations. The burden of a generous price-index and wage-index inked, unfunded lifetime pension and family pension results in an open-ended liability on future generations for past services rendered, undermining intergenerational equity.

The unsustainable nature of OPS is corroborated by the fact that the pension burden under OPS has sharply risen faster than the revenues of State governments over the years. The annual compound growth rate of pensions during the period 2004–05 to 2022-23 was 15.02%, resulting in the pension outgo surging from ₹37,378 crore (₹373.78 billion) in 2004–05 to ₹4,64,533 crore (₹4.64 trillion) in 2022–23, a twelve-fold increase (Figure 2), while the States' own revenues grew 8.6 times during this period at a compound annual rate of 12.7% (Annexure 4).



India is the only large country that has historically committed to providing unfunded, open-ended, generous, price and wage index-linked pensions exclusively for government employees. This creates a long-term liability that places an immense and unsustainable burden on future governments and successive generations. In stark contrast, most democracies operate on funded pension systems where the current generation contributes towards its future benefits through social security taxes or reserve funds, ensuring there is no blanket liability on future governments.

For instance, nearly 94% of the workforce in the United States is covered under the universal social security program, Old Age, Survivor, and Disability Insurance (OASDI). This program is funded through payroll taxes from workers and employers, with benefits financed by a dedicated Trust Fund. The average annual social security benefit in the US amounts to approximately 25% of per capita

income.[4] In contrast, in India, the average pension payment to retired government employees is several times the per capita income. For example, in 2021–22, the average pension for government employees in the State of Andhra Pradesh amounted to 277% of the State's per capita income.[5]

The contrast becomes even more apparent when examining the share of general government revenues allocated to pensions. In the US, pensions or social security payments account for 15% of government revenues while covering 94% of the workforce. In India, however, 14% of general government revenues are spent on pensions (Annexure 5) for a mere 3.2% of the workforce[6]. This disproportionate and unfunded allocation to a limited section of the workforce raised serious concerns especially when public finances are already under strain.

Recognising this, the Union and all States except West Bengal, embraced the fully funded defined contribution scheme of National Pension Scheme (NPS) for all new recruits after 2004. NPS would begin to have an impact on public finances from about 2035; as the employees recruited after 2004 start retiring, the pension burden on the exchequer will taper off over the next two decades, and will finally cease by about 2060. This will free up significant resources for development and welfare. The recent reversal of policy in several States and embracing the unfunded OPS spells disaster to future public finances.

The Unified Pension Scheme (UPS) recently introduced by the Union government strikes a balance between the NPS and OPS. Retaining the funded nature of NPS while incorporating a defined benefit element, UPS ensures fiscal responsibility by funding the future pensions and transparently reflecting liabilities in current

[4] Foundation for Democratic Reforms. (2023). *Preserving Growth Momentum: A Politically Viable Framework for Fiscal Prudence*.
[5] ibid
[6] ibid

budgets. States must consider UPS as a viable alternative to OPS, allowing them to meet pension obligations sustainably while unlocking resources for critical investments in infrastructure, healthcare, and education in future.

The danger still remains if States do not adopt NPS/UPS and continue with the fiscally draining OPS. It is crucial to establish measures to prevent the emergence of open-ended liabilities similar to those under OPS. Constitutional provisions may need to be invoked to ensure that States contemplating a reversal to OPS or resisting NPS/UPS bear the cost of future liabilities today. Mechanisms such as requiring the States to establish sinking funds and enforcing stricter oversight under Article 293 can help ensure that pension liabilities are fully funded, predictable, transparent, and fiscally sustainable. These safeguards are essential to protect public finances, maintain intergenerational equity, and secure long-term fiscal stability.

1.1.3. The Cost of Fiscal Neglect

Left unaddressed, the pattern of fiscal mismanagement risks pushing States into an irreversible debt trap. This would leave States unable to meet their financial obligations. Such a scenario would stifle development and erode public trust in governance, creating widespread socio-economic instability.

The Indian Constitution does not provide for the bankruptcy of States. This provision ensures that no State is left to its own devices during a fiscal crisis. Instead, the Union is empowered to act as the ultimate guarantor of financial stability across all levels of government. Under Article 360, the Constitution allows for the declaration of a financial emergency when the financial stability or credit of any part of India is threatened. Similarly, Article 293 enables the Union to regulate State borrowing, imposing conditions to ensure fiscal sustainability and

prevent fiscal mismanagement. These constitutional safeguards reflect the view of the makers of the Constitution that, in the final analysis, the Union and the States constitute a single entity for fiscal management and that the final responsibility for financial stability and preserving the credit of India rests with the Union. While these provisions serve as essential safeguards, invoking a financial emergency is a last resort due to its significant administrative and political costs. Transferring day-to-day expenditure management to the Union would disrupt State-level governance. The political price of such measures is also immense in a complex, multi-party, federal polity.

In order to avoid such drastic interventions, additional mechanisms with robust safeguards may be required, provided States commit to reducing their revenue deficits over time and fostering fiscal discipline. There are two ways to address the potential debt trap situation. Placing a debt moratorium would temporarily halt debt repayments, allowing States to focus on restoring their public finances without the immediate pressure of servicing their debt. Alternatively, revenue expenditures such as interest payments on existing loans, welfare expenditure and wage increase could be frozen for a few years to provide fiscal relief. However, these measures alone are insufficient without complementary reforms. Sustained economic growth, projected at 6–7% real and 11–12% nominal, offers a critical opportunity to expand revenue streams and ease fiscal pressures if liabilities are contained. Clearly, any and all measures taken to address the impending fiscal collapse in some States have to be uniform, non-partisan and subject to the States accepting strict measures for curtailing current expenditure. And finally preventive measures should be in place to ensure that no State in future falls into a debt trap.

Fiscal prudence must be prioritised to ensure that rising revenues are not offset by escalating liabilities or imprudent expenditures. To achieve this, it is essential to build a national consensus on the importance of fiscal discipline and the need for sustainable financial practices. The Union and the States must commit to curbing profligate expenditures while channeling resources toward growth-oriented investments. A coordinated approach will be critical to maintaining India's growth trajectory, safeguarding public trust, and preserving financial stability. By focusing on growth-enhancing reforms and managing public finances prudently, India can mitigate fiscal risks, unlock its full economic potential, and secure a prosperous future for all its citizens. Such measures are not only vital for addressing immediate fiscal challenges but also for laying the groundwork for inclusive and sustainable growth in the years to come.

1.2. Unfinished Agenda of Defence Pension Reforms

The issue of pensions extends beyond States to the national level, with defence pensions posing a distinct and urgent challenge. The One Rank One Pension (OROP) scheme introduced in 2015, with its wage-indexed, direct-benefit structure, has significantly increased the financial strain on defence budgets. Pension outlays have grown at a compound annual growth rate (CAGR) of 14.3% between 2015–16 and 2022–23, outpacing the 10% growth in total defence expenditure. In comparison, capital investments grew at just 9.4% CAGR during this period, highlighting how rising pension costs are constraining resources needed for modernisation (Annexure 6).

Salaries and pensions alone now account for a staggering 54% of the total defence budget (Annexure 6), putting immense pressure on resources that should be allocated to upgrading defence infrastructure, acquiring advanced

technology, and modernising the forces. The disproportionate allocation towards pensions and salaries has led to a situation where there is limited fiscal room to ensure that India's military stays on par with rapidly advancing global defence capabilities. As sophisticated defence technologies emerge across the world, we risk falling behind in modernising our forces, undermining national security and strategic readiness. This poses a direct challenge to both the fiscal stability and long-term defence preparedness of the country.

The recent Agnipath initiative is a step towards reducing the future pension burden, but its scope remains narrow. Under this scheme, Agniveers recruited on short-term contracts are not entitled to gratuity and pensionary benefits, potentially saving over ₹34,500 crore (₹345 billion) annually in pension expenditure.[7] A more comprehensive framework is needed to address the escalating costs of defence pensions. Exploring solutions such as transitioning to a Unified Pension Scheme model for defence personnel and creating a dedicated sinking fund could mitigate future liabilities. These reforms are essential not only for safeguarding fiscal stability but also for ensuring that adequate resources are available for the modernisation of defence capabilities.

The Seventh Pay Revision Commission (PRC) report provides a framework for reforming the defence pension system. It recommends the government explore the possibility of transitioning to a defined contributory pension scheme[8], similar to practices followed by countries like South Korea, Australia, and New Zealand. These nations have adopted contributory schemes to ensure fiscal sustainability. Alternatively, the government could factor in future defence liabilities under a defined benefit pension scheme in the current budgets, as practiced in the United

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[7] Foundation for Democratic Reforms. (2023). *Preserving Growth Momentum: A Politically Viable Framework for Fiscal Prudence*.
[8] Government of India. (2015). *Report of the Seventh Central Pay Commission* (pp. 381–427).

States. Given the demands on budgetary resources in an emerging economy, some variant of the funded UPS system seems to be sustainable. This approach would allow for better management of long-term financial obligations and provide a more sustainable solution to rising pension costs, ensuring resources are available for modernisation and operational readiness.

1.3. Power Sector Challenges and Implications

Curbing revenue deficits and improving public finances acquire great urgency in the context of two present and impending developments that will further weaken public finances. For long, electricity has been supplied at subsidised rates, leading to significant financial crises in the power sector. The annual losses for power distribution companies average ₹63,000 crore (₹630 billion)[9] due to inefficiencies and unmetered power use. By the end of FY 2022–23, the total debt burden of State power utilities was of the order of ₹6,61,000 crore (₹6.61 trillion)[10], with an annual interest burden of above ₹50,000 crore (₹500 billion) (assuming an interest rate of 8% per annum). By the end of FY 2024–25, the debt burden of these utilities will be of the order of ₹7,80,000 crore (₹7.8 trillion). As power utilities continue to suffer losses, eventually this rising debt burden will be borne by the State exchequer (Figure 3).

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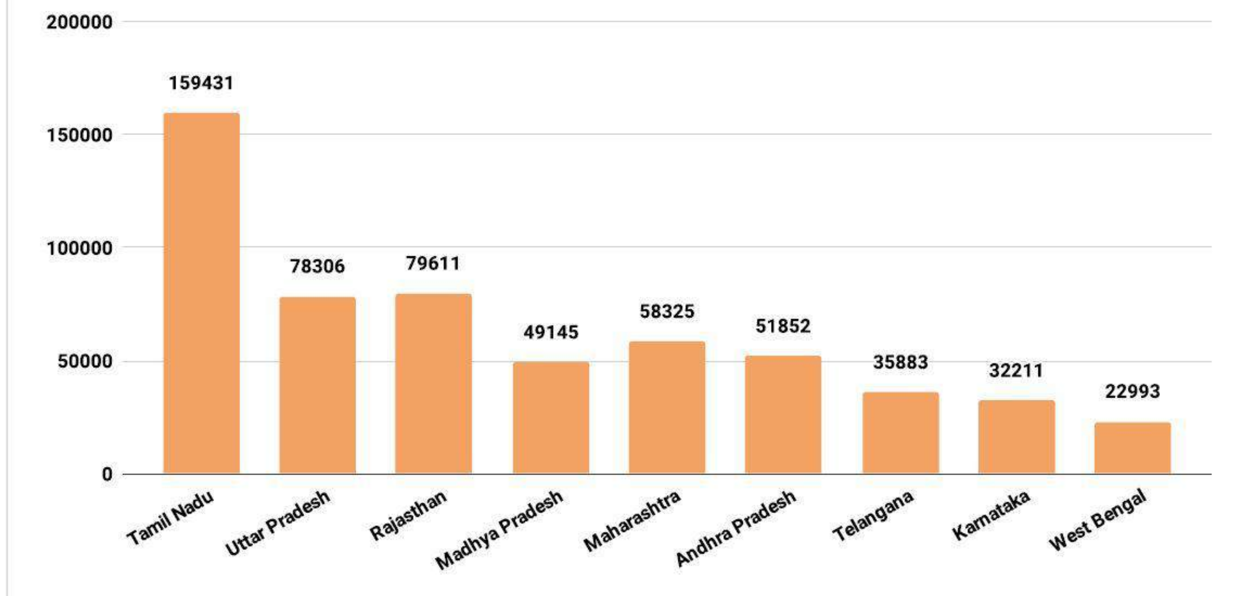
[9] Power Finance Corporation Ltd. (2024). Report on Performance of Power Utilities 2022-23.
[10] Power Finance Corporation Ltd. (2024). Report on Performance of Power Utilities 2022-23.



These challenges will be compounded by the inevitable energy transition. As high-paying customers switch to renewable sources like rooftop solar, utilities will continue to service agriculture and low-end consumers whose tariffs do not recover costs. Simultaneously, utilities must maintain base-load stations for night-time needs of all consumers, and must honour Power Purchase Agreements with Independent Power Producers.

The energy transition's additional burden will almost certainly fall on the exchequer, as current tariffs and duties cannot be increased significantly. Global studies estimate the cost of energy transition at $15 trillion, with India's share projected at $1 trillion (₹80 lakh crore) over the next two to three decades. Right now, our fiscal projections and FRBM norms do not take into account this significant increase in the financial burden on the States in coming years on

account of energy transition. A detailed examination is needed to address this imminent challenge to public finances.

1.4. Challenges and Opportunities in Fiscal Management

India's fiscal situation faces mounting pressures across multiple fronts, including unsustainable State debt, rising pension liabilities, challenges in the power sector, and the high costs of transitioning to a renewable energy economy. Compounding these are systemic issues like off-budget accounting, deferred financial obligations, and a growing misalignment between current spending priorities and long-term growth objectives. These fiscal strains not only threaten immediate financial stability but also hinder critical investments in infrastructure, rule of law, education, and healthcare – areas that are essential for driving economic productivity and reducing poverty. As of today, India ranks in the bottom seven among 55 large economies in terms of most infrastructure and socio-economic development indicators (Annexure 7). Given these interconnected challenges, safeguarding future finances requires a comprehensive approach that strengthens public finance management. This can be achieved through well-defined fiscal rules and governance frameworks that curb fiscal profligacy, promote accountability, and ensure that resources are directed toward long-term growth and development.

While India's fiscal challenges are significant, the country's economic trajectory offers a reason for optimism. India is in a growing phase, with real GDP growth projected at 6–7% and inflation expected to stabilise at 4–6%, resulting in a nominal growth rate of approximately 12% per annum. Over the next five years, this growth trajectory could lead to a ~76% increase in nominal GDP (compounded). This rise in GDP will also drive higher revenues, providing a

robust foundation to address fiscal pressures, provided short-term fiscal stress is addressed and debt burden is not allowed to escalate uncontrollably.

With this growth momentum, public finances can be restored to sound health through targeted measures. Freezing welfare expenditure at current levels or allowing only moderate increases well below the nominal growth rate, while ensuring revenue growth through economic expansion, can significantly reduce the debt-to-GDP burden. As debt levels moderate, fiscal pressures would ease, providing greater fiscal flexibility to channel resources toward long-term growth priorities such as infrastructure, education, healthcare, and rule of law.

However, achieving these goals requires more than just the control of expenditure. Institutional reforms, including the strengthening of fiscal responsibility frameworks and the establishment of robust governance and monitoring mechanisms, are essential to ensure that resources are effectively aligned with growth-oriented objectives. By maintaining fiscal discipline and aligning spending with growth objectives, India can sustain high growth rates, reduce poverty, and unlock its vast potential, paving the way for inclusive and sustainable progress.

1.5. A Framework for Effective Fiscal Management

The Fifteenth Finance Commission recommended a three-pillar approach for the twenty-first century fiscal architecture.[11] The approach includes: first, fiscal rules across all levels of government which set the institutional and budgetary framework for fiscal sustainability; second, a public financial management system that provides complete, consistent, reliable, and timely reporting of the

[11] Fifteenth Finance Commission. (2020). *Finance Commission in Covid Times: Report for 2021-26* (p. 379).

fiscal indicators that are part of the first pillar; and third, an independent assessment mechanism to provide assurance and advice on the working of the other two pillars. Based on this approach, the following could be the key features of a viable framework for ensuring fiscal prudence at the Union and State levels.

1.5.1. Union Oversight of State Debt

The fundamental principle that informed the constitution-makers in determining the fiscal relations between the Union and the States is that India is one indivisible economic unit. It is also noteworthy that the Constitution does not provide for bankruptcy of States. In times of grave crisis, the Constitution provides for Union government intervention to restore financial stability.[12] In a federal structure, the argument that States in a federation ought to manage their revenue generation and expenditure according to their local needs and conditions is valid. However, in India, the Union is the ultimate guarantor of fiscal and financial stability, and States cannot go bankrupt. In the final analysis, all public debt is general government debt, and there is an implicit Union guarantee of all public debt. That is why Article 360 (excerpt given below) provides for the proclamation of financial emergency and transfers the fiscal responsibility to the Union –

> (1) *If the President is satisfied that a situation has arisen whereby the financial stability or credit of India or of any part of the territory thereof is threatened, he may by a Proclamation make a declaration to that effect.*
>
> …

[12] INDIA CONST. art. 360.

(3) *During the period any such Proclamation as is mentioned in clause (1) is in operation, the executive authority of the Union shall extend to the giving of directions to any State to observe such canons of financial propriety as may be specified in the directions, and to the giving of such other directions as the President may deem necessary and adequate for the purpose.*

(4) *Notwithstanding anything in this Constitution –*

(a) *any such direction may include –*

(i) *a provision requiring the reduction of salaries and allowances of all or any class of persons serving in connection with the affairs of a State;*

(ii) *a provision requiring all Money Bills or other Bills to which the provisions of article 207 apply to be reserved for the consideration of the President after they are passed by the Legislature of the State;*

(b) *it shall be competent for the President during the period any Proclamation issued under this article is in operation to issue directions for the reduction of salaries and allowances of all or any class of persons serving in connection with the affairs of the Union including the Judges of the Supreme Court and the High Courts.*

From the explicit wording of Article 360, it is clear that the constitution-makers recognised that the threat to the financial stability of any part of the territory of India is a threat to the financial stability and credit of all of India. The explicit

powers of the Union to deal with such a threat include giving "directions to any State to observe such canons of financial propriety as may be specified," directing reduction of salaries and allowances of all or any class of public servants, and a direction requiring all Money Bills to be reserved for the consideration of the President after they are passed by the State Legislature. Clearly, the Constitution does not envisage a State or a constituent unit of the Indian Union going bankrupt and left to its own devices. The Union is the guarantor of the financial stability and credit of India across all tiers of government.

Article 293 is essentially a framework to ensure that States have the total autonomy as per the local economic needs and political judgement subject to the boundaries fixed by the needs of protecting the financial stability and credit of India, sustainability and intergenerational equity. There is a need to judiciously and equitably apply the powers conferred on the Union government under Article 293, clauses (3) & (4) of the Constitution of India, particularly in the context of the Indian fiscal framework. Article 293 (excerpt given below) gives the Union the authority to monitor and regulate the fiscal health of States –

> (3) *A State may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government.*
>
> (4) *A consent under clause (3) may be granted subject to such conditions, if any, as the Government of India may think fit to impose.*

Article 293 clearly is not aimed at restricting the political choices or policies of a State. However, the financial stability of a State is regarded as vital, and should be protected by the Union. Article 293(3) confers on the Union control over borrowing by States, the condition being that the State be previously indebted to the Union, and the mechanism being that such State shall require the prior consent of the Union for further borrowing. Article 293(4) goes beyond a debt limit, and empowers the Union to impose such conditions as deemed fit to protect the financial stability and fiscal future of the State.

1.5.2. Transparent Accounting – Off-Budget Borrowings and Deferred Expenditure to be Fully Reflected in the Budgets and Real-Time Public Disclosures

The practice of off-budget borrowings allows States to bypass fiscal responsibility norms with impunity. Therefore, all off-budget borrowings through SPVs, and government guarantees as loans to public entities should be required to be fully disclosed in the budget, as well as to the Union government. With respect to reports of banks refusing to disclose lending to State governments to appropriate authorities, it should be noted that while client confidentiality is an important principle of running businesses, borrowings by governments cannot be covered by such privilege in a democratic society. Therefore, statutory provisions should mandate full disclosure by banking institutions of all lendings to States and public entities.

Moreover, data collection and monitoring of off-budget borrowings are currently inadequate. For example, data pertaining to off-budget borrowings by the State of Andhra Pradesh, as collected at the Union level, is incomplete and inconsistent. The State, by its own admission, has disclosed significantly higher figures than those recorded by the Union government, underscoring the discrepancy in fiscal

data reporting (Table 1). Such inadequate and often contradictory information undermines the credibility of financial management systems and impedes effective policy decisions.

Table 1: Discrepancies in Reported Data for Off Budget Borrowings, Andhra Pradesh

Source	Amount Reported as Off Budget Borrowings (2022-23)
Comptroller and Auditor General[1]	₹1,28,048 Crore
Department of Expenditure, Ministry of Finance[2]	₹1,976 Crore

Source:

1. State Finances Audit Report for the year ended 31 March 2023 pertaining to Government of Andhra Pradesh (Report 2 of 2024).

2. Off Budget Borrowing declared by State Government, accessed at doe.gov.in

To rectify this, there is an urgent need for a stronger mechanism to ensure consistent and authoritative data collection and monitoring across all levels of government. The body responsible for monitoring debt must not only oversee the reporting of fiscal data but also regularly engage with State governments to reconcile discrepancies. This would ensure that fiscal figures are reliable, comprehensive, and reflective of the true financial position of States.

There are reports that many State governments are simply postponing non-discretionary expenditure in order to conceal the real state of public finances. It is vital that deferred, non-discretionary expenditure is transparently accounted for in full. Appropriate rules should be framed in the application of Article 293(3) and in respect of conditions imposed under Article 293(4). In respect of the Union government also such transparent accounting should be mandated and monitored by an appropriate authority like a Fiscal Council or the Public Accounts Committee of Parliament. A robust system of data collection and monitoring, combined with statutory mandates for transparency, is essential to strengthen fiscal discipline. A digital platform for real-time public disclosure of

the health of public finances of the Union and the States – including the public debt as on that date, off-budget loans, unpaid bills, interest on debt – is long overdue. There should be internal monitoring of fiscal health within the government, strengthened by public awareness and pressure from the general public generated by accurate, real-time disclosure. Such a framework would improve accountability and enhance public trust in fiscal management.

1.5.3. Zero Revenue Deficit

The golden rule, as recommended by the 13th Finance Commission, asserts that borrowing must be reserved for investment purposes only and the government is not to utilise national savings to finance consumption (paras 9.18, 9.19, 9.70, 13th Finance Commission 2009). This principle emphasises that governments should aim to maintain a zero revenue deficit over the long term, ensuring that borrowed money is utilised solely to finance investments that promote economic growth rather than for short-term expenditures.

Adopting the golden rule establishes a robust fiscal framework by limiting borrowed funds to investments and confining current expenditure to current revenues. Evaluating and monitoring each Individual Short-Term Welfare (ISW) program at federal level is neither feasible nor desirable in a politically polarised environment. Adherence to this golden rule offers a practical approach to strengthening public finances without interfering in the government's autonomy. Given our social norm of thrift and protecting income and assets of future generations, a simple norm of not applying borrowed money for committed expenditure and ISW, and limiting all current or revenue expenditure to current revenues with no revenue deficit would be the most pragmatic and effective method of improving public finances.

In addition to the existing norms under the FRBM Act, such as the Fiscal Deficit (FD) and Debt-GSDP ratio, Revenue Deficit targets should be reinstated for both the Union and the States. Notably, the Revenue Deficit target was removed from the Union government's FRBM framework in the Finance Act 2018. A period of three years may be allowed to meet this target by the Union as well as the States, with the condition that the revenue deficit demonstrates a steady and significant decline during this period. States that already have no revenue deficits should be encouraged to show a continuous increase in revenue surpluses. In respect of the Union, the Parliament and appropriate independent authority should monitor compliance of the zero revenue deficit rule, and in respect of the States, appropriate conditions should be imposed under Article 293(4). Once the State's ability to raise new loans is contingent upon the condition of zero revenue deficit, compliance will be automatic. It goes without saying that the revenue deficit should take into account the Off-budget loans and unpaid bills.

1.5.4. Phase out Revenue Deficit Grants

Special grants have been provided to States to address Revenue Deficits, creating a perverse incentive for overspending on revenue items and increasing dependence on Union grants without financial consequences. The 15th Finance Commission had recommended phasing out these Revenue Deficit Grants by the end of its award period. It is now essential to implement this phase-out to ensure that the burden of fiscal mismanagement in States is not transferred to the Union government. The Finance Commission formula and the special dispensation for the Special Category States together take into account the unique needs of the States while devolving funds. Therefore, norms of fiscal prudence should apply to all States equally. The Zero Revenue Deficit norm and future revenue surplus norms should be uniformly applied to all States on a permanent basis. This

recommendation complements the golden rule by reinforcing the need for responsible fiscal management and eliminating the Union support for revenue deficits, and thus removing a perverse incentive.

1.5.5. Independent Exercise of Functions under Article 293

Our federalism is robust, marked by fierce political competition and a clear division of powers between the Union and States. However, with different political parties elected to office at the Union and State levels, the exercise of functions under Article 293 by the Union can easily be viewed through partisan lenses, potentially breeding mistrust and discord. Transparency, fairness, and credibility are therefore indispensable for ensuring harmonious functioning in a complex federal democracy such as ours.

While the Union's role in protecting the financial stability and credit of India is enshrined in the constitutional framework, safeguards are essential to remove public perception of partisan political considerations influencing public financial management at the State level. It will be best to entrust these functions to a professionally competent, independent, credible authority. The Finance Commission (FC), established under Article 280, is uniquely positioned to play this role, given its competence, credibility, and acceptance across the political spectrum. To achieve this, the FC must be made a permanent body, akin to the Election Commission of India. Article 280 of the Constitution mandates that *"The President shall,…at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission…to be appointed by the President…"*. There are strong legal arguments that suggest that the FC can be made a permanent body within the existing provisions of Article 280, and a set of new Chairman and members may be appointed every five years.

Utilising this provision, the FC may be made a permanent body, and if deemed necessary, appropriate amendment to Article 280 may be carried out. Parliament may make a law entrusting the monitoring of the fiscal health of the Union and States and exercising the functions under Article 293 to such a permanent FC.

Alternatively, a Fiscal Council, as recommended by the FRBM Review Committee 2017, could be constituted with similar functions. Whether through a permanent FC or a Fiscal Council, the entrusted authority must have the power to monitor the fiscal health of the Union and the States, ensuring that consent for State borrowings under Article 293 is subject to adherence to zero revenue deficit/revenue surplus targets and other conditions necessary for fiscal stability.

By insulating these functions from the appearance of partisan control and placing them under an independent, credible institution, India can safeguard its federal harmony while strengthening public financial management. Such measures would not only protect the fiscal health of the Union and the States but also bolster trust in the financial management processes critical to the functioning of our democracy.

1.5.6. Independent Monitoring and Analysis of Fiscal Situation

In order to enhance fiscal responsibility and transparency in a growing economy, the 13th Finance Commission proposed the establishment of an independent body that could initially conduct an annual public review of the implementation of FRBM processes including a review of the fiscal impact of policy decisions. Eventually, the Commission hoped that this body could evolve into a full-fledged Fiscal Council that acts autonomously. The Commission noted that similar arrangements in other countries have proven to be highly effective in medium-term fiscal policy and design (paras 9.65 and 9.66, 13th Finance

Commission 2009). The 14th Finance Commission expanded on the Fiscal Council's role to undertake an ex-ante assessment of fiscal policy and fiscal implications (paras 14.100 and 14.101, 14th Finance Commission 2015). These bodies – Congressional Budget Office (CBO) in the United States of America (U.S.A.), Office for Budget Responsibility (OBR) in the United Kingdom (UK) and Parliamentary Budget Office (PBO) in Australia serve as fiscal watchdogs, and impart greater transparency and accountability to the legislature and public at large. The Commission recommended an amendment to the FRBM Act to mandate the establishment of an independent Fiscal Council. The 15th Finance Commission underscores the need for such a mechanism as the third pillar of fiscal architecture (paras 13.51 to 13.58, 15th Finance Commission 2020). While the structure of these bodies varies globally, there is a consensus on the need for an effective, independent, non-partisan, and clear legal framework for ex-ante assessment. The Commission suggests that the key functions of the Council should include ex-ante monitoring and assessment, as well as an evaluation of the effective implementation of the revenue, expenditure, and deficit targets, with powers to access records as required. The FRBM Review Committee Report emphasised the direct contribution of Fiscal Councils in strengthening public information and discourse about fiscal policy (Chapter 7, FRBM Review Committee, 2017).

Independent, accurate and credible analysis, forecasts and costings of programmes are vital for a viable framework for fiscal prudence. In the UK, the Office for Budget Responsibility (OBR) was created in 2010, and given statutory status as a non-departmental public body under the Budget

Responsibility and National Audit Act 2011[13]. Its core functions include forecasts of the economy and public finances, evaluation of the government's performance against its fiscal targets, scrutiny of government's policy costings, assessment of the long-term sustainability of the public finances, and welfare spending analysis. OBR does not take any position on the policies or welfare programmes proposed, and does not make any policy recommendations. Similarly, the U.S.A. created the Congressional Budget Office (CBO) in 1974 as a nonpartisan body to produce independent analysis of budgetary and economic issues to support the Congressional budget process. With similar functions, and on the same lines, institutions exist in other countries – e.g. Parliamentary Budget Office in Australia, and Fiscal Councils in several OECD countries.

Building on these global best practices, it is essential to create an equivalent body within India's fiscal framework, modelled on the OBR in the UK, with powers to assess fiscal policies, monitor expenditure, and provide independent forecasts. Strengthening this body through legal mandates will ensure that major public finance proposals undergo thorough analysis, enhancing the quality of fiscal decision-making

Given the significant variations in fiscal practices as discussed in the section 'Inter-State variation in fiscal prudence, it becomes crucial to establish a mechanism for monitoring and evaluating the fiscal health of States. It becomes crucial to introduce additional tools for monitoring State finances. One such tool is the '*fiscal stress test*'; borrowed from the banking sector. The FC or Fiscal Council can be entrusted with the task of conducting regular stress tests to assess the resilience of State finances under various economic scenarios. These

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[13] Office for Budget Responsibility , & HM Treasury. (2019). *Office for Budget Responsibility and HM Treasury: Framework Document*.

tests would evaluate critical indicators such as debt-to-GSDP ratios, revenue deficit, interest payments and committed expenditure as a share of revenues, and trends in capital expenditure. By regularly assessing these indicators, States' fiscal health can be evaluated more accurately, and early signs of fiscal stress can be identified. Prompt corrective action can then be initiated well before the fiscal stress degenerates into a full-blown crisis.

In addition to stress tests, the independent body should also take on the role of conducting ex-ante assessments of State-level fiscal policies and practices. This would align with the core functions of similar institutions globally, providing an unbiased and transparent evaluation of the fiscal implications of State policies. Such a framework will not only ensure that fiscal prudence is maintained at the State level but also help prevent the kind of fiscal stress observed in some States from poor fiscal practices.

While local contexts may differ, the principles of prudent financial management remain universal. A centralised framework for monitoring, combined with periodic consultations between the Union and the States, can ensure greater transparency and accountability in public finance management.

1.5.7. Cost-Benefit Analysis of Large Infrastructure Projects

Once the zero-revenue deficit norm is implemented fairly and uniformly, fiscal profligacy will give way to fiscal prudence. However, governments sometimes do take up unviable, large vanity projects, investments which cannot be justified by any meaningful cost-benefit analysis. The fact that such lavish expenditure is incurred under capital account does not promote the health of the public finances if the benefits are marginal, public finances are strained, debt burden is unsustainable, and the returns on investment are paltry or negative. In this

context, monitoring revenue deficits alone may not be adequate; keeping track of large capital expenditure and subjecting big projects to close scrutiny is necessary to protect the future health of public finances.

Therefore, very large public projects proposed by governments should be subjected to cost-benefit analysis by the OBR-like organisation proposed above. The authority to monitor fiscal health and accord approval for borrowing under Article 293 should have the power to withhold consent for borrowing if the cost-benefit analysis shows that it will adversely affect the long-term health of public finances.

1.5.8. Addressing Commitments Posing Future Liabilities

As States make various commitments that impose future liabilities, such as pension schemes or other long-term obligations, a pressing need arises to safeguard the fiscal future of these States. For example, five States have committed to reverting to the unfunded Old Pension Scheme (OPS), and West Bengal has never opted for the National Pension Scheme (NPS). However, the risk of such decisions leading to fiscal instability is not limited to pensions alone. Any commitment that imposes future financial burdens, whether through pension schemes or other long-term expenditure programs, must be closely managed to avoid creating unsustainable fiscal liabilities.

In order to prevent future fiscal crises without infringing upon the sovereign rights of elected State governments, it is essential to institutionalise mechanisms that protect the financial stability of both the States and the Union. As previously discussed, the Union has a constitutional mandate under Article 293(4) to regulate borrowing by States. Given that these long-term commitments could push States into future debt spirals, it is incumbent upon the Union to ensure that

such commitments are made responsibly, protecting the interests of both the people of the States and the country as a whole.

While the choice of any expenditure scheme, including pension plans, is a matter for States to negotiate and decide with their electorate, the Constitution provides the framework to ensure that such choices do not jeopardise the nation's financial future. A government elected for a finite period should not have the power to create unfunded, irrevocable commitments affecting future generations. In the best of circumstances, there is a clash between short-term political gain and long-term public good in democratic politics. If the financial liability of current decisions is transferred to future generations, there is a dangerously perverse incentive to pursue short-term political gain at no political cost within a reasonable period of 5–10 years. Therefore, norms of fiscal prudence should safeguard intergenerational equity.

In this context, the following pre-condition may be imposed by the Union (or the independent institution exercising that authority) under Article 293(4):

> Funds equivalent to the current value of future liabilities, calculated with the appropriate discount factor, are to be allocated in the budgets for the years in which the liabilities are incurred

This condition is based on fairness and justice, ensuring that the future liability is funded in the current budget, so that there is no unjust burden on the future generation of taxpayers for the services rendered to the current generation. In other words, unfunded liabilities cannot be incurred by current governments.

The same principles and canons that apply to the States should equally apply to the Union government. The Union as well as the States should also refrain from

imposing future unfunded liabilities. In line with this, a sinking fund must be established to manage the Union's long-term liabilities, ensuring that future generations are not burdened with obligations arising out of current commitments. NPS and UPS are two good models of creating a fund through current allocations to meet future expenditure liabilities.

1.5.9. Addressing the Legacy Problem of Fiscally Stressed States

The legacy problem of fiscally distressed States requires immediate corrective action to create fiscal room and establish robust mechanisms to ensure that such a situation does not repeat. The Union, under Articles 293 and 360 of the Constitution, bears both the responsibility and the power to ensure fiscal stability across the country. While the Union cannot directly control State spending, it has the authority to regulate borrowing and intervene in times of fiscal crisis. In the absence of market discipline, it is important to create institutional mechanisms. In respect of the Union too there should be constant monitoring and timely action to prevent fiscal crisis. The Union has the inbuilt safeguards of the market – global rating agencies, interest rates, stock market, investment climate. But the States are insulated from market conditions as loans can easily be raised at relatively low interest rates irrespective of a State's fiscal health, provided the loans are approved by the Union under Article 293.

In the absence of market discipline, it is important to create institutional mechanisms to improve fiscal discipline in States. However, achieving long-term fiscal health also demands a fresh political consensus that transcends political cycles and electioneering. If we allow elections to become a clash between economic populism and growth, without instituting necessary safeguards, the prospects of sustained high growth over the next two to three decades will

vanish. To prevent this, we must create a political consensus among all stakeholders, including States and the Union, to prioritise fiscal prudence over populist pressures. In order to tackle the issues of welfare expenditure and restoration of fiscal health of stressed States, a high-powered committee consisting of public finance experts and Chief Ministers should be established. This committee would be tasked with evaluating the current state of welfare programs, and recommending reforms to ensure that welfare spending is aligned with fiscal realities. The Committee should also identify one-time measures to be implemented to restore fiscal health of stressed States and preventive measures aimed at ensuring that in future States do not slip into fiscal crisis. This collaborative approach will foster shared responsibility for managing public finances, ensuring that reforms are viewed as collective efforts, rather than top-down mandates. Without these measures, the fiscal health of some of the States will continue to deteriorate, and we may eventually reach a point where basic expenditures, including salaries, cannot be met, as evidenced by the deferral of payments in a few States. Only through decisive action and a commitment to fiscal responsibility can we secure India's future and maintain the growth trajectory needed to lift millions out of poverty.

1.5.10. Accrual System of Accounting

As discussed, many States are incurring revenue deficits and borrowing to cover current expenditures, including committed and ISW expenditure. This borrowing imposes a debt servicing burden on future revenues. Additionally, there have been instances where a State government's unpaid bills, which are not accounted for in the budget, have reached alarming levels.

In this context, the cash-based accounting system conceals the actual costs incurred and fails to capture the future financial burden of current government policies. To address these issues, it is appropriate to consider the 12th Finance Commission's recommendation (excerpt given below) for a gradual transition from cash-based accounting to accrual accounting.

> 14.14 *The cash based system of accounting…does not record and report complete financial information required for management of resources. It does not provide a full picture of the government's financial position at any given point and the changes that take place over time as a result of government policy. The system fails to reflect government's liabilities such as accrued liabilities arising due to unfunded pensions and superannuation benefits and current liabilities arising from a disconnect between commitments and payments….*
>
> ….
>
> 14.16 *….The system of accrual accounting, thus, inter alia, allows better cost – price calculations, records capital use properly, distinguishes between current and capital expenditures, presents a complete picture of debt and other liabilities and focuses policy attention on financial position, as shown in the whole balance sheet not just cash flows or debts….*

The FRBM Review Committee Report (Chapter 2, FRBM Review Committee Report, 2017) echoes similar recommendations, making reference to the Sarma Committee's emphasis on the importance of the government's openness on its fiscal projections. In line with the same, the report recognises the benefits of the introduction of an accrual accounting system. There is a wide recognition that

the cash-accounting system does not recognise hidden liabilities arising out of unpaid bills. The transition to a system of accrual accounting will ensure better fiscal transparency, providing the proposed permanent FC or Fiscal Council with a clearer understanding of the state of public finances, thereby enabling more informed decisions when applying Article 293 (3) and (4) to regulate States' borrowings.

1.6. Conclusion

The most important faultline emerging in our electoral politics in recent times is between long-term growth and short-term fiscal profligacy without increasing assets and growth momentum. The prevalence of such polarised atmosphere in a poor democracy, short-term populism will win hands down most of the time. World over, even in rich countries, voters prefer ISW. Fiscal profligacy in the form of short-term populism and unfunded, open-ended liabilities poses the greatest and most immediate danger to India's growth prospects.

There is a need to build a fresh consensus on long-term fiscal health if we are to enjoy long-term, sustained high growth and prosperity. We need to establish a broadly acceptable fiscal framework that balances short-term populism with growth, and simultaneously ensuring institutional safeguards to protect future generations from reckless populism and fiscal profligacy. The principles of fiscal propriety that apply to the States must be equally observed by the Union government. While commendable steps toward fiscal consolidation have been undertaken in recent years, it is essential that these efforts persist irrespective of political transitions. India cannot afford to miss the opportunity to strengthen its economic foundations during this pivotal period. The Union must take the lead in safeguarding the nation's fiscal and financial stability. Successive governments

should operate within this overarching framework of fiscal responsibility, continuing with programs that align with the long-term objectives of sustained economic growth, fiscal discipline, and inter-generational equity.

2. Empowering Local Governments to Sustain Growth Momentum

India has emerged as the fastest-growing economy among large nations. However, our government is too centralised. Over the past three decades, the States have become increasingly powerful and are in control of their destiny. This is a healthy development in a federal polity. But our weakest link of federalism is the emasculated third tier of local governments. Empowering local governments is key to maintaining this momentum towards healthy federalism, strengthening democracy and promoting citizens' participation and greater public awareness. Local governments serve as 'schools of democracy', where citizens can understand the connection between their votes and public goods, as well as the taxes they pay and the services they receive. Empowered local governments enable active engagement of citizens, creating a strong foundation for democracy and legitimacy. This enables people to influence decisions that affect their daily lives, enhancing their trust and participation in governance. Once citizens understand the link between their quality of life and effective governance, it becomes politically feasible to pursue long-term goals such as improving infrastructure, healthcare, and rule of law, all of which are essential for sustained economic growth.

2.1. Fiscal Prudence and De-Subsidisation

There have been growing concerns about the misallocation of public resources and the rise of unchecked, reckless competitive populism at the cost of the primary responsibilities of the State. Rule of law, delivery of justice, quality healthcare, basic amenities, and infrastructure are all underfunded and suffering

neglect at the altar of short-term vote-catching Individual Social Welfare (ISW) measures. This tendency is aggravated in a centralised regime because people do not directly perceive the alternative benefits they receive by giving up a subsidy. For instance, a household that is currently receiving a cooking gas subsidy is asked to give it up for vague notions of national good. For a struggling family, it is hard to give up a certain benefit in exchange for a vague promise of future good. But if these subsidies are administered locally, and people see the alternative use of additional public funds saved by de-subsidization, there is a greater likelihood of people making an informed choice between short-term subsidies and valued public goods like safety on the streets and water supply. Clearly, empowered local governments and innovative resource management at the local level can radically alter our fiscal landscape, promote prudence, and help focus on public goods.

2.2. Decentralisation and Competition: The Case of China

In this context, it is useful to examine China, where local governments have played a crucial role in driving rapid economic growth. Local governments, empowered both financially and functionally, account for over 50% of the total public expenditure in the country.[14] Additionally, provinces that empower local governments by devolving more financial resources are incentivised with increased financial support from the national government. Leaders of high-performing local governments are rewarded, fostering a competitive environment to attract investment and stimulate economic growth.

[14] National Bureau of Statistics of China. (2023). *China statistical yearbook 2023*.
The calculation was based on a sample of three provinces (Gansu, Shanxi, Henan) and Shanghai Municipality, considering all levels of government from the county level and below as Local Governments.

2.3. Local Governments in India: Fiscal Scenario

However, local governments in India are under-powered and hardly have any financial resources at their disposal. The share of local governments in total public expenditure in the country is 3%. A comparison with other countries clearly shows that this is just a fraction of what local governments spend elsewhere (Table 2).

Table 2: General Government Expenditure in Select Countries (% Share)

Country	Federal Government	State/ Provincial Government	Local Government
Brazil	63	21	16
Canada	36	47	17
China	15	31	54
Germany	51	32	17
South Africa	47	32	21
Spain	53	35	12
United States	56	22	22
India	39	58	3

Note:
1. General government expenditure includes spending by all levels of government.
2. Data corresponds to the years 2021, 2022, and 2023 for the United States, China, and India, respectively, while for other countries, it is for the year 2020.
3. For China, calculations are based on a sample of three provinces (Gansu, Shanxi, Henan) and Shanghai Municipality, considering all levels of government from the county level and below as local governments.
4. For the United States, intergovernmental transfers from the Federal Government to State and Local Governments and from State Governments to Local Governments have been deducted to determine their respective shares.
5. For India, transfers from the Union Government to State and Local Governments and from State Governments to Local Governments have been deducted to determine their respective shares.

Sources:
Brazil; Canada; Germany; South Africa; Spain
1. OECD. (2018). OECD-UCLG World Observatory on Subnational Government Finance and Investment.
China
2. National Bureau of Statistics of China. (2023). China statistical yearbook 2023.
3. Survey Offices of the National Bureau of Statistics in Gansu, Shanxi, Henan, & Shanghai. (2023). Statistical yearbooks of Gansu, Shanxi, Henan, Shanghai 2023.
United States
4. U.S. Census Bureau. (2021). Annual Survey of State and Local government finances: 2021.
5. Congressional Budget Office. (2021). The Federal Budget in fiscal year 2021.
India
6. Reserve Bank of India. (2022). Report on Municipal Finances.
7. Reserve Bank of India. (2024). Finances of Panchayati Raj Institutions.
8. Ministry of Finance. (2024). Union budget documents 2024.

The Union government transfers a substantial share of its revenues to the States in the form of devolution (States' share) from the divisible pool of taxes. However, the transfers to local governments, as a share of the total devolution to States,

have been very limited. Most States, despite the constitutional provisions relating to the State Finance Commissions, devolve very few resources to local governments. Kerala is the only significant exception to this dismal neglect of local governments.

Table 3: Annual Transfers to Local Governments	
Finance Commission	Annual transfers from the Union Government to Local Governments as a percentage of the total devolution to States (%)
XII FY 2006 to FY 2010	3.5
XIII FY 2011 to FY 2015	5.3
XIV FY 2016 to FY 2020	7.8
XV FY 2021 to FY 2026	7.8

Details are available in Annexure 8.
Note:
1. The percentages have been calculated as a share of the devolution, averaged over the Finance Commission period.

Sources:
1. Union Budget documents for the respective years.
2. Reports of the Finance Commission.

2.4. Empowering Local Governments

Clearly, if India is to sustain its growth momentum in the long term, local governments must be empowered. This will enable citizens to understand and experience the benefits of such growth through increased employment opportunities and an improved quality of life. The Union already devolves a substantial portion – 41%,[15] to be exact – of the divisible pool of taxes to the

[15] *'As per accepted recommendations of the Fifteenth Finance Commission, the States' share has been fixed at 41% of the net proceeds of shareable Central Taxes.'*
Fifteenth Finance Commission. (2020). *Finance Commission in Covid Times: Report for 2021-26* (p. 379).

States. As explained in the section '*Ensuring Long-Term Fiscal Stability for Sustained Growth*' of the current document (Pg. 11), the total transfers from the Union to the States are of the order of ~55% of the revenues of the Union. However, the transfers from the Union to local governments, when calculated as a share of devolution to the States, remain significantly low and should be gradually increased. Additionally, systems of accountability should be institutionalised for local governments to ensure effective governance.

2.4.1. Progressive Devolution

The Union transfers to local governments should be progressively increased to 30% of the devolution (States' share) over the next 10 to 15 years. By making these transfers as a share of devolution, the allocation becomes predictable, akin to a right, rather than remaining discretionary or uncertain. As the portion of funds allocated to local governments increases over time, it will result in a greater flow of financial resources. This gradual increase in funding would also encourage States to transfer more functions and functionaries to local governments. In other words, higher share to local governments need not starve the States. As the burden of functionaries commensurate to the resources devolved, there will be no fiscal stress. States can institute strong mechanisms to improve local government delivery and hold them accountable. Such a process will improve delivery, strengthen accountability and promote public participation and awareness – all without, in any way, upsetting the fiscal health of the States. Over time this will lead to maturation of our polity and a democracy dividend. At the same time, the Union is not overburdened either, since the sum of devolution to the States and local governments will remain the same as a share of the Union's revenues. However, these Union transfers to local governments should not be unconditional. They should be contingent on States progressively

increasing their own financial transfers to local governments. In order to ensure compliance, the Finance Commission should establish clear devolution benchmarks for States to meet this requirement.

2.4.2. Accountability Mechanisms

- Comprehensive citizen's charters covering all deliverable, predictable services should be institutionalised and enforced in local governments. The charter should specify reasonable timelines for each service, a mechanism to redress grievances and compensate citizens for delays in service delivery.
- An independent Ombudsman should be constituted for every district and city, with a minimum tenure of five years. The Ombudsmen will enforce citizen charters, have the authority to investigate complaints of corruption and abuse of power, and possess the power to remove offenders from office or impose other suitable penalties. The State government should also retain monitoring authority through the district administration to investigate and rectify any wrongdoing.
- The State government should create a formal institutional mechanism for every local government, where local governments and State officials meet regularly to facilitate review and monitoring by the State, and to coordinate and resolve pending issues.

3. Development of Small Towns as Engines for Inclusive Growth

The agriculture sector in India contributes 18% to the national GDP while employing 42%[16] of the population. About 65% of the population still resides in villages. Globally, as the contribution of agriculture to GDP declines and human needs extend beyond food, there is an inevitable shift of the population towards secondary and tertiary sectors, often driving migration to urban areas. Over the past two centuries, urbanisation, modernisation, and economic growth have become synonymous.

India too reflects this trend; however, the pace of urbanisation has been significantly slower compared to other large and emerging economies. The insufficient livelihood opportunities in agriculture have led to migration, primarily In India to large cities. Distant migration to large cities has two consequences: migration becomes self limiting as big metropolises can only absorb a small proportion of the population; and inadequate infrastructure for the burgeoning poor, low skills and low wages, and isolation and alienation of migrant workers make urban poverty and congestion unbearable. Most of the migrants in India are low-skilled and can only expect a low wage in the market. With 80–90% of the workforce in India unorganised, the migration pressures, urban challenges and the severity of urban poverty are bound to grow.

[16] Ministry of Finance, Government of India. (2024). *Economic Survey 2023-24.*

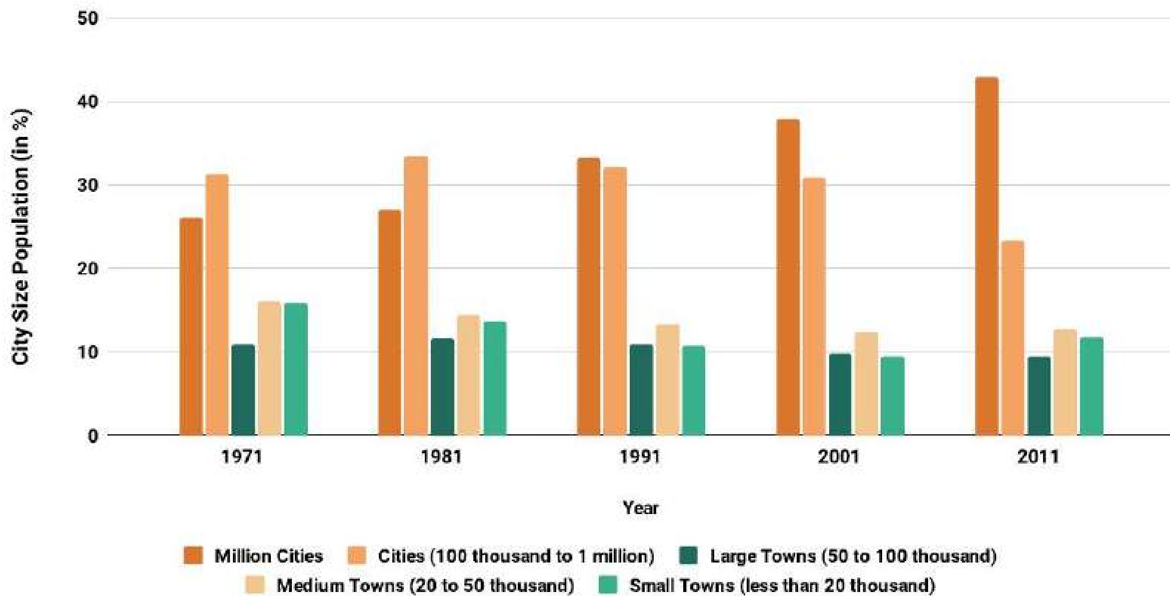

Figure 4: Urban Population Distribution as per City Size Class

Source: International Institute for Population Sciences; more details in Annexure 9. Chart prepared by FDR.

The rapid overcrowding in major cities has resulted in inadequate water supply, housing, stormwater drainage leading to frequent urban flooding, and severe traffic congestion. As of 2020, 49% of India's urban population resided in slums[17], underscoring the unsustainable nature of this trend. The migration of high-skilled workers to big cities is both inevitable and desirable. However, for low-skilled workers, the scenario is starkly different. Many of them migrate to big cities due to the lack of job opportunities in their villages or nearby towns. In these cities, they earn meagre incomes and live in slums, isolated from their families, as they cannot afford decent housing with their limited wages. Increasingly, urban poverty is becoming more severe and debilitating than rural poverty. Low-skilled, low-income workers in distant big cities are often isolated from their families and have no social support system to tide over a crisis. Loss of livelihood for a few

[17] UN-HABITAT. (2024). *World Cities Report 2024: Cities and Climate Action*.

days or sickness become catastrophic. The sufferings endured by these migrant workers during the Covid pandemic are seared in our collective memory.

With 80% of Indian villages having populations under 2,000,[18] building and maintaining infrastructure, such as roads and drainage systems of adequate quality, for these small villages is practically and economically not feasible. Even a developed nation like the United States faces similar challenges in constructing and maintaining essential infrastructure in rural areas. Clearly, there is a need to reimagine India's current approach to urbanization.

Happily, over the past three decades 24-hour electricity, mobile phones, television, and digital infrastructure have reached most corners of the country. Therefore, the many advantages big cities offered in earlier decades are now available in small towns closer to rural habitats. In situ urbanisation and local migration and generation of local employment are more feasible and necessary than ever before.

Developing small towns as urban magnets and creating jobs in labour-intensive industries such as apparel, footwear, food processing, electronic goods, light consumer manufacturing, tourism, and construction can help manage migration more efficiently. This strategy will promote inclusive growth for low-skilled and semi-skilled workers, offering them a better quality of life closer to their villages. People will always be free to migrate to wherever they like; but with in situ urbanisation most low-skilled workers will find it more convenient to live in small towns. Natural migration will take place over time to these small towns which are close to their original habitats.

[18] Office of the Registrar General and Census Commissioner, India. (2011). *Census of India 2011.*

3.1. Parameters for Identification of such Small Towns

- At least one (1) per Assembly constituency
- Centrally located with adequate connectivity
- A natural social and economic hub that people from neighbouring villages regularly visit for various purposes, such as healthcare, travel, or recreation.

3.2. Infrastructure Development and Town planning

An investment of ₹100 crore (₹1 billion) over a five-year period in each small town for basic infrastructure development, including quality drinking water, stormwater drainage, transport networks, and sanitation facilities, supported by proper town planning, can attract migration from surrounding villages. This, in turn, stimulates private investments in housing, education, healthcare, and leisure services. As a result, vibrant small towns will emerge, offering a quality of life comparable to big cities, especially as services like mobile phones, internet, digital connectivity, and TV are now nearly universally accessible. Such in-situ urbanization encourages organic migration from villages while reducing distress migration to larger urban centres. A relatively low wage of ₹10,000–15,000 per month in a small town can provide a better quality of life than a wage of ₹30,000–40,000 per month in a distant big city. In addition to lower cost of living and better quality of life, the families can live together in a small town, and there are strong social support systems locally available. The alienation, isolation, poor quality of life, and constant fear and uncertainty that characterise the life of the migrant poor in big cities can all be overcome in small towns through in situ urbanisation.

Development of small towns as hubs of growth to absorb the large number of

low-skilled migrants is a critical requirement of inclusive growth. Therefore, the FC may set apart a significant portion of local government grants for in situ urbanisation. With this fund, supplemented by their own devolution, the States can provide critical infrastructure, especially transport systems, and town planning services. With this stimulus, the private sector will quickly enter and boost economic activity and job creation.

3.3. Labour Intensive Industries

India's potential to generate employment in labour-intensive sectors remains largely untapped. With the right infrastructure and incentives, small towns can transform into hubs for labour-intensive manufacturing units, providing jobs for the low and semi-skilled workforce from the neighbouring villages. A noteworthy example is the Brandix India Apparel City in Atchutapuram, Andhra Pradesh, which manufactures apparel for leading global brands and employs 22,000 individuals from 600 surrounding villages, including 18,000 women in low and semi-skilled positions.[19] In order to facilitate the establishment of such labour-intensive industries, it is essential to create a conducive environment for investment by developing adequate infrastructure, ensuring land availability, and removing compliance hurdles through the implementation of labour reforms, while simultaneously enhancing the skills of the workforce in the neighbouring villages.

In today's times, urbanisation, economic growth, and modernisation go hand in hand. However, the current trend of urbanisation, where large cities serve as the primary destinations, leads to overcrowding and a poor quality of life for urban migrants. In this context, the socio-economic benefits of developing small towns

[19] Balasubramanian, R. (2019, March). *YourStory*.

are substantial. Small towns foster a strong network between agriculture and industry, and by focusing on labour-intensive industries, a significant number of low-skilled jobs can be created. They enhance access to healthcare and education by generating economies of scale for private investment. Furthermore, social ties are preserved, as individuals have the flexibility to live and work in either their village or a nearby small town. Special incentives for in situ urbanisation in the form of conditional Finance Commission devolution will help this process of in situ urbanisation and inclusive growth.

* * *

FDR FOUNDATION for DEMOCRATIC REFORMS

Annexures

Annexure 1: Fiscal Position of the Union

Annexure 1: Fiscal Position of the Union (₹ Crore)			
	Heads	**2023-24 RE**	**2024-25 BE**
A	Gross Revenue of the Union Government	36,96,235	40,96,737
B	Resources Transferred to States and UTs with Legislatures	20,37,748	22,77,343
	Devolution of States share in Taxes	11,04,494	12,47,211
	Other Transfers including Finance Commission Grants and Centrally Sponsored Schemes	9,33,254	10,30,132
	Resource Transfer as % of Gross Revenue	**55.1%**	**55.6%**
C	**Net Revenue with the Union after Transfers (A-B)**	**16,58,487**	**18,19,394**
D	Salaries and Pensions (including Defence)	7,42,448	7,82,063
E	Interest Payments	10,63,871	11,62,940
F	**Structural Deficit of the Union (A-B-D-E)**	**-1,47,832**	**-1,25,609**

Note:
1. Structural Revenue Deficit of the Union Government = [Gross Tax Revenue + Non-Tax Revenue excluding Dividends and Profits] - [Devolution of States share in Taxes + Other Transfers to States + Salaries and Pensions + Interest Payments]
2. Gross Revenue of the Union Government includes Gross Tax Revenue (before Devolution and Transfers to States) and Non-Tax Revenue (excluding Dividends and Profits).
3. Other Transfers include Centrally Sponsored Schemes, Finance Commission Grants, and Other Grants/ Loans/ Transfers.

Sources:
Gross Revenue; Interest Payments
1. Budget at a Glance, Union Budget Document of 2024-2025
Transfer of Resources
2. Budget at a Glance (Full), Union Budget Documents of 2024-2025 pg. 8.
Salaries
3. Expenditure Full Profile, Union Budget Documents of 2024-2025
Pensions
4. Expenditure Full Profile, Union Budget Documents of 2024 - 2025.

Annexure 2: General Government Expenditure in India

Annexure 2: General Government Expenditure in India				
Year	Level of Government	Expenditure[1]		
		Amount (₹ Crore)	As a share of GDP (%)	As a share of General Government Expenditure (%)
2015-16	**General Government**	**37,60,611**	**27.31**	
	State and Local Governments	23,60,229	17.14	62.76
	Union Government	14,00,382	10.17	37.24
2016-17	**General Government**	**42,65,969**	**27.72**	
	State and Local Governments	27,08,216	17.60	63.48
	Union Government	15,57,753	10.12	36.52
2017-18	**General Government**	**45,15,946**	**26.42**	
	State and Local Governments	29,24,600	17.11	64.76
	Union Government	15,91,346	9.31	35.24
2018-19	**General Government**	**50,40,747**	**26.67**	
	State and Local Governments	33,37,713	17.66	66.21
	Union Government	17,03,034	9.01	33.79
2019-20	**General Government**	**54,10,887**	**26.92**	
	State and Local Governments	34,95,002	17.38	64.59
	Union Government	19,15,885	9.53	35.41
2020-21	**General Government**	**63,53,359**	**32.00**	
	State and Local Governments	36,97,492	18.70	58.20
	Union Government	26,55,867	13.30	41.80
2021-22	**General Government**	**70,98,451**	**30.10**	
	State and Local Governments	42,29,930	18.00	59.59
	Union Government	28,68,521	12.10	40.41
2022-23	**General Government**	**80,69,963**	**29.94**	
	State and Local Governments	47,93,015	17.79	59.39
	Union Government	32,76,948	12.16	40.61
2023-24 RE	**General Government**	**92,19,235**	**31.21**	
	State and Local Governments	57,71,165	19.54	62.60
	Union Government	34,48,070	11.67	37.40
2024-25 BE	**General Government**	**100,03,042**	**30.65**	
	State and Local Governments	62,84,299	19.26	62.82
	Union Government	37,18,743	11.39	37.18

RE: Revised Estimates **BE**: Budget Estimation

Note:
1. Union Governments Expenditure here is calculated by subtracting State and Local Governmentss' expenditure from General Governments Expenditure. Figures for Union Governments Expenditure as a percentage of GDP are approximately 0.2 to 0.7% lower than the figures if calculated based on the expenditure amounts taken from Union Governments's Budget documents (Union's expenditure after Transfers to State and Locals).

Source:
1. Economic Survey 2023-24.
2. Budget at a Glance, Union Budget 2024-25
3. State and Local Governments: A Study of Budgets of 2024-25, Reserve Bank of India.

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Annexure 3: Fiscal Profile of Select States

Annexure 3a: Fiscal Profile of Select States (2022-23 Actuals)

Annexure 3a: Fiscal Profile of Select States (2022-23 Actuals)					
States	Debt to GSDP ratio	Interest Payments as a share of		Committed Expenditue as a share of	
		State's Own Revenues (%)	Total Revenue (%)	State's Total Revenues	State's Own Revenues
Andhra Pradesh	42.4%	49.1%	26.0%	74%	141%
Gujarat	19.0%	16.4%	11.8%	43%	60%
Himachal Pradesh	46.1%	35.8%	12.7%	79%	225%
Jharkhand	31.4%	16.4%	7.8%	35%	74%
Karnataka	27.9%	16.0%	12.4%	45%	58%
Kerala	41.9%	28.9%	19.0%	67%	102%
Maharashtra	19.5%	14.2%	10.3%	52%	71%
Odisha	23.1%	6.2%	3.7%	37%	63%
Punjab	50.6%	41.1%	22.7%	80%	145%
Rajasthan	45.0%	28.4%	15.7%	59%	107%
Tamil Nadu	35.9%	28.0%	19.2%	61%	88%
Telangana	48.6%	27.8%	22.1%	55%	69%
Uttar Pradesh	38.3%	22.9%	10.3%	53%	119%
West Bengal	39.9%	46.6%	20.5%	64%	146%

Annexure 3b: Fiscal Profile of Select States (2023-24 Revised Estimates)

Annexure 3b: Fiscal Profile of Select States (2023-24 Revised Estimates)					
States	Debt to GSDP ratio	Interest Payments as a share of		Committed Expenditue as a share of	
		State's Own Revenues (%)	Total Revenue (%)	State's Total Revenues	State's Own Revenues
Andhra Pradesh	44.9%	48.10%	25.86%	68%	127%
Gujarat	18.1%	16.4%	11.7%	44%	62%
Himachal Pradesh	46.1%	35.1%	14.0%	76%	191%
Jharkhand	31.1%	16.7%	7.9%	35%	74%
Karnataka	26.5%	17.6%	13.5%	53%	70%
Kerala	40.6%	28.6%	21.2%	72%	97%
Maharashtra	19.6%	16.1%	10.0%	49%	79%
Odisha	16.8%	6.3%	3.6%	36%	62%
Punjab	50.3%	36.6%	22.7%	77%	123%
Rajasthan	44.0%	26.3%	14.5%	56%	101%
Tamil Nadu	34.4%	27.3%	20.1%	62%	84%
Telangana	46.8%	28.2%	22.7%	56%	70%
Uttar Pradesh	40.6%	22.0%	9.4%	47%	110%
West Bengal	39.1%	44.1%	20.3%	63%	137%

*Data from this table has been used to generate Figures **1A** and **1B**.*

Annexure 3c: Fiscal Profile of Select States (2024-25 Budget Estimates)

Annexure 3c: Fiscal Profile of Select States (2024-25 Budget Estimates)					
States	Debt to GSDP ratio	Interest Payments as a share of		Committed Expenditue as a share of	
		State's Own Revenues	Total Revenue (%)	State's Total Revenues	State's Own Revenues
Andhra Pradesh	57.6%	59.68%	35.73%	82%	137%
Gujarat	18.4%	17.76%	13.04%	46%	62%
Himachal Pradesh	46.0%	33.35%	14.84%	79%	178%
Jharkhand	30.8%	13.19%	6.40%	30%	61%
Karnataka	27.4%	19.29%	14.91%	58%	75%
Kerala	39.8%	27.79%	20.69%	71%	95%
Maharashtra	20.2%	15.34%	11.36%	55%	75%
Odisha	17.1%	4.78%	2.70%	35%	62%
Punjab	49.9%	34.07%	22.99%	76%	112%
Rajasthan	41.7%	25.33%	14.19%	55%	98%
Tamil Nadu	33.2%	27.65%	20.89%	64%	84%
Telangana	44.6%	23.86%	18.70%	42%	54%
Uttar Pradesh	41.2%	18.2%	8.9%	53%	109%
West Bengal	38.7%	41.66%	19.20%	58%	125%

Notes and Sources for Annexures 3a, 3b, 3c

Note:

1. **All parameters in the table have been calculated using data from the Reserve Bank of India and the respective State Budget documents.**
2. Debt-to-GSDP ratio includes guarantees provided by the respective State Governments. Debt and guarantee amounts (₹) have been sourced from *State Finances: A Study of Budgets* published by the Reserve Bank of India, while GSDP figures have been obtained from the respective State budgets. The ratio has been calculated accordingly. For all States except Andhra Pradesh and Telangana, data has been taken from *State Finances: A Study of Budgets*. For Andhra Pradesh and Telangana, information has been obtained from the detailed White Papers on State Finances published by the respective State Governments.
3. Interest payment data for all States, except Andhra Pradesh, Telangana, and Odisha, has been derived from their State Budget documents. For Andhra Pradesh and Telangana, where significant Off-Budget Borrowings exist that are serviced by the State Governments, the following sources have been used:
a) For Andhra Pradesh, data has been taken from the White Paper on State Finances.
b) For Telangana, an assumed interest rate of 6.24 percent per annum has been used, calculated as a percentage of interest payments to the total outstanding debt excluding guarantees for the year 2022-23. Interest payments for the years 2022-23, 2023-24, and 2024-25 have been calculated based on the total outstanding liabilities, including guarantees.
4. For guarantees and salaries, where the 2024-25 BE figures are unavailable, the most recent available figures have been considered.
5. Salaries, pensions, and interest payments for Odisha has been taken from *State Finances: A Study of Budgets* published by the Reserve Bank of India, as these details are not comprehensively available in the State Budget documents.
6. State's Own Revenues comrpise Own Tax Revenue and Own Non-Tax Revenue.
7. State's Total Revenues comprise Own Tax Revenue, Own Non-Tax Revenue, as well as Devolution and Transfers from the Union Government.

Sources:

Debt-to-GSDP ratio

1. Reserve Bank of India. (2024). *State finances: A Study of Budgets.*

Interest Payments

1. Andhra Pradesh: Finance Department, Government of Andhra Pradesh. (2024, July). White Paper on State Finances.
2. Odisha: Reserve Bank of India. (2024, December). State finances: A Study of Budgets.
3. Telangana: Calculated by Foundation for Democratic Reforms (FDR).

State's Own Revenue; Total Revenue

1. Budget documents of the respective States, FY 2024-25

Annexure 4: Pension Burden of States

Annexure 4: Pension Burden of States		
Year	Pension Outgo (in ₹ Crore)	States' Own Revenues (in ₹ Crore)
2004-05	37,378	2,36,670
2005-06	40,733	2,71,580
2006-07	46,965	3,28,550
2007-08	56,218	3,78,610
2008-09	65,606	4,19,520
2009-10	83,445	4,70,580
2010-11	1,08,514	5,75,270
2011-12	1,28,099	6,78,700
2012-13	1,45,124	7,97,910
2013-14	1,63,474	8,74,630
2014-15	1,83,499	9,53,473
2015-16	2,04,686	10,34,936
2016-17	2,26,772	11,17,616
2017-18	2,75,361	13,10,098
2018-19	3,14,865	14,33,590
2019-20	3,45,505	14,84,884
2020-21	3,68,834	13,47,554
2021-22	4,18,314	17,19,437
2022-23	4,64,533	20,43,969
CAGR (2004-05 to 2022-23)	15.02%	12.72%

The data in the table has been used to generate Figure 2.
RE: Revised Estimates; **CAGR:** Compound Annual Growth Rate

Note:
1. Pension Expenditure is for States and Union Territories with Legislature.
2. States' Own Revenues include Own Tax Revenue and Own Non-tax Revenue.

Source:
Pension Expenditure; States' Own Revenue
1. Handbook of Statistics on Indian States 2021-22, Reserve Bank of India.
2. State Finances: A Study of Budgets, Reserve Bank of India for the years 2022-23, 2023-24, and 2024-25

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Annexure 5: Burden of Pension Expenditure, Union and States Combined (in ₹Crore, FY 2022-2023 RE)

Annexure 5: Burden of Pension Expenditure, Union and States Combined (in ₹ Crore; FY 2022-2023 RE)		
S.No.	Heads	Figures
a	Pension Expenditure of the Union	2,96,633
b	Pension Expenditure of all States and UTs	4,64,533
c	Total Pension Expenditure (a+b)	7,61,166
d	Union Government Revenue [1]	32,39,700
e	States' Own Revenue [2]	20,43,969
f	Total Government Revenue (d+e)	52,83,669
h	**Total Pension Expenditure as a Share of Revenue [c/f]**	**14.41%**

UTs: Union Territories with Legislature; **RE:** Revised Estimates

Note:
1. Union Government Revenue includes Gross Tax Revenue (before Devolution and Transfers to States) and Non-Tax Revenue (excluding Dividends and Profits).
2. States' Own Revenue includes Own Tax Revenue and Own Non-tax Revenue.

Source:
Pension Expenditure of all States Combined; States' Own Revenues
1. State Finances: A Study of Budgets of 2024-25, Reserve Bank of India.
Pension Expenditure of the Union
2. Expenditure Profile, Union Budget Documents 2024-25.
Union's Gross Tax Revenues
3. Budget at a Glance, Union Budget Documents 2024-25.

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Annexure 6: Defence Expenditure Profile

Annexure 6: Defence Expenditure Profile							
Fiscal Year	Total Expenditure (₹ Crore)	Capital Outlay		Salaries		Pensions	
		Amount (₹ Crore)	Share of Total Expenditure (%)	Amount (₹ Crore)	Share of Total Expenditure (%)	Amount (₹ Crore)	Share of Total Expenditure (%)
2015-16	2,93,920	79,958	27.2	74,200	25.2	60,238	20.5
2016-17	3,51,551	86,371	24.6	86,945	24.7	87,826	25.0
2017-18	3,79,704	90,445	23.8	1,34,355	35.4	92,000	24.2
2018-19	4,03,459	95,231	23.6	1,41,508	35.1	1,01,775	25.2
2019-20	4,52,996	1,06,483	23.5	1,47,973	32.7	1,17,810	26.0
2020-21	4,85,681	1,31,803	27.1	1,45,885	30.0	1,28,066	26.4
2021-22	5,00,681	1,44,786	28.9	1,47,471	29.5	1,16,800	23.3
2022-23	5,73,098	1,50,896	26.3	1,57,131	27.4	1,53,407	26.8
CAGR (%)	**10**	**9.4**		**11.3**		**14.3**	

CAGR: Compound Annual Growth Rate
Sources:
Total Expenditure,Capital Outlay and Pensions
1. FY 2015-2016 to 2018-2019 - Report of Fifteenth Finance Commission pg. 335,pg. 336,pg. 337.
2.FY 2019-2020 to 2022-2023 - Demand for Grants Analysis (respective years), Defence; PRS Legislative Research.
Salaries
3. FY 2017-2018 to 2020-2021 - Lok Sabha reply, unstarred question no. 3225, dated 05.08.2022.
4. FY 2015-2016,2016-2017,2021-2022 & 2022-2023 - Demand for Grants Analysis (respective years), Defence; PRS Legislative Research.

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Annexure 7: Comparison of Countries across Select Socio-Economic Indicators

Annexure 7: Comparison of Countries Across Select Socio-Economic Indicators

Rank	GDP Per Capita (PPP, 2023)	Life Expectancy (2022)	IMR (Infant Mortality Rate, 2022)	MMR (Maternal Mortality Rate, 2020)	OOPE (Out-of-Pocket Expenditure on Healthcare, 2021)	EYS (Expected Years of Schooling, 2022)	MYS (Mean Years of Schooling, 2022)	HDI (Human Development Index, 2022)	Power Consmuption (Kwh Per capita, 2019)	Employment in Agriculture (% of total employment, 2022)	LFPR (Labor Force Participation Rate - Female, 2022)
1	Ireland	Japan	Hong Kong	Norway	South Africa	Australia	Germany	Switzerland	Norway	Singapore	Vietnam
2	Switzerland	Hong Kong	Japan	Poland	France	Greece	Switzerland	Norway	Qatar	Hong Kong	New Zealand
3	Norway	Switzerland	Norway	Australia	Thailand	Turkey	Canada	Hong Kong	Sweden	Israel	Peru
4	Singapore	Australia	Singapore	Spain	Netherlands	New Zealand	United States	Sweden	Canada	Belgium	Qatar
5	United States	Sweden	Finland	Israel	Saudi Arabia	Finland	Israel	Denmark	UAE	United Kingdom	Sweden
6	Denmark	Spain	Sweden	Czechia	UAE	Ireland	United Kingdom	Ireland	Finland	Germany	Netherlands
7	Australia	Ireland	Czechia	Hong Kong	Ireland	Sweden	Poland	Germany	United States	Canada	Singapore
8	Netherlands	Italy	Italy	Netherlands	United States	Argentina	Norway	Singapore	South Korea	UAE	Kazakhstan
9	Austria	Singapore	South Korea	Japan	New Zealand	Belgium	Denmark	Australia	Saudi Arabia	United States	Australia
10	Sweden	New Zealand	Spain	Germany	Japan	Denmark	New Zealand	Netherlands	Australia	Sweden	Norway
11	Finland	Israel	Austria	Ireland	Germany	Norway	Finland	Belgium	Singapore	Netherlands	Switzerland
12	Belgium	South Korea	Portugal	Austria	Denmark	Netherlands	Czechia	Finland	France	Denmark	Canada
13	Canada	Norway	Ireland	Belgium	Czechia	Hong Kong	UAE	United Kingdom	Belgium	Norway	Israel
14	UAE	France	Israel	Italy	Sweden	Spain	Australia	New Zealand	New Zealand	Australia	China
15	Germany	United Kingdom	Germany	Denmark	United Kingdom	United Kingdom	Sweden	UAE	Israel	Switzerland	Thailand
16	Israel	Netherlands	Denmark	Sweden	Colombia	Germany	Japan	Canada	Japan	Czechia	Denmark
17	Hong Kong	Belgium	Belgium	Singapore	Australia	UAE	South Korea	South Korea	Czechia	France	Ireland
18	United Kingdom	Portugal	Australia	Switzerland	Norway	Singapore	Netherlands	United States	Russia	Saudi Arabia	Finland
19	New Zealand	Denmark	Hungary	New Zealand	Canada	Portugal	Belgium	Austria	Austria	Japan	United Kingdom
20	France	Canada	France	South Korea	Austria	Chile	Kazakhstan	Japan	Switzerland	Austria	United States
21	Italy	Finland	Greece	Finland	Finland	Italy	Russia	Israel	Netherlands	Finland	Austria
22	Japan	Austria	Netherlands	France	Turkey	Switzerland	Hong Kong	Spain	Germany	Italy	Germany
23	South Korea	Germany	Switzerland	Greece	Belgium	South Korea	Austria	France	Ireland	Spain	Malaysia
24	Spain	Greece	United Kingdom	UAE	Israel	United States	Hungary	Italy	China	Ireland	Russia
25	Czechia	Thailand	Poland	United Kingdom	Poland	Austria	Singapore	Czechia	Kazakhstan	Hungary	UAE
26	Saudi Arabia	Chile	Russia	Romania	Romania	Czechia	France	Greece	Spain	Portugal	South Korea
27	Portugal	UAE	New Zealand	Canada	Spain	France	Ireland	Poland	Denmark	South Korea	Portugal
28	Greece	Czechia	UAE	Portugal	Italy	Canada	South Africa	Saudi Arabia	Greece	Russia	Japan
29	Hungary	China	Canada	Kazakhstan	Argentina	Poland	Greece	Portugal	Malaysia	New Zealand	Brazil
30	Poland	Turkey	China	Russia	Singapore	Russia	Romania	Chile	Italy	Chile	Hungary
31	Romania	Saudi Arabia	Chile	Hungary	Brazil	Thailand	Saudi Arabia	Turkey	Portugal	Argentina	Spain
32	Chile	United States	United States	Chile	Switzerland	Brazil	Argentina	Hungary	Hong Kong	Poland	Hong Kong

Annexure 7: Comparison of Countries across Select Socio-Economic Indicators

Annexure 7: Comparison of Countries Across Select Socio-Economic Indicators											
Rank	GDP Per Capita (PPP, 2023)	Life Expectancy (2022)	IMR (Infant Mortality Rate, 2022)	MMR (Maternal Mortality Rate, 2020)	OOPE (Out-of-Pocket Expenditure on Healthcare, 2021)	EYS (Expected Years of Schooling, 2022)	MYS (Mean Years of Schooling, 2022)	HDI (Human Development Index, 2022)	Power Consumption (Kwh Per capita, 2019)	Employment in Agriculture (% of total employment, 2022)	LFPR (Labor Force Participation Rate - Female, 2022)
33	Mexico	Poland	Romania	Saudi Arabia	Hungary	Algeria	Chile	Argentina	Poland	Iraq	France
34	Russia	Algeria	Saudi Arabia	Egypt	Kazakhstan	Japan	Malaysia	Romania	United Kingdom	Brazil	Indonesia
35	Argentina	Malaysia	Malaysia	Turkey	Peru	China	Italy	Russia	Chile	Algeria	Czechia
36	Kazakhstan	Argentina	Thailand	United States	Russia	Saudi Arabia	Spain	Malaysia	Turkey	Malaysia	Argentina
37	Turkey	Hungary	Turkey	Malaysia	Indonesia	Hungary	Peru	Thailand	Iran	Greece	Nigeria
38	China	Romania	Argentina	Iran	Portugal	Israel	Egypt	Iran	South Africa	Mexico	Colombia
39	Malaysia	Mexico	Kazakhstan	China	South Korea	Kazakhstan	Iran	Kazakhstan	Argentina	Kazakhstan	South Africa
40	Brazil	Vietnam	Iran	Thailand	Hong Kong	Peru	Portugal	China	Brazil	Colombia	Belgium
41	Peru	Iran	Colombia	Argentina	Chile	Iran	Mexico	Mexico	Romania	Iran	Poland
42	Thailand	Kazakhstan	Mexico	Mexico	Malaysia	Romania	Philippines	Peru	Mexico	Turkey	Philippines
43	Colombia	Bangladesh	Peru	Peru	Greece	Mexico	Colombia	Brazil	Thailand	Romania	Chile
44	South Africa	Colombia	Brazil	Brazil	China	Colombia	Thailand	Colombia	Vietnam	Egypt	Italy
45	Iraq	Brazil	Egypt	Colombia	Iran	South Africa	Turkey	Algeria	Iraq	South Africa	Mexico
46	Algeria	Peru	Vietnam	Iraq	Algeria	Indonesia	Indonesia	Egypt	Egypt	China	Greece
47	Indonesia	Russia	Indonesia	Philippines	Vietnam	Vietnam	Vietnam	Vietnam	Cuba	Philippines	Romania
48	Iran	Philippines	Algeria	Algeria	Mexico	Malaysia	Brazil	South Africa	Peru	Peru	Turkey
49	Vietnam	Iraq	Iraq	India	Philippines	Egypt	China	Indonesia	Colombia	Indonesia	Saudi Arabia
50	Philippines	Egypt	Philippines	Bangladesh	India	Philippines	Nigeria	Philippines	India	Thailand	India
51	Egypt	Indonesia	Bangladesh	Vietnam	Iraq	India	Bangladesh	Iraq	Indonesia	Vietnam	Bangladesh
52	Bangladesh	India	India	South Africa	Egypt	Iraq	Algeria	Bangladesh	Philippines	Pakistan	Pakistan
53	India	Pakistan	South Africa	Pakistan	Pakistan	Bangladesh	Iraq	India	Pakistan	Bangladesh	Egypt
54	Nigeria	South Africa	Pakistan	Indonesia	Bangladesh	Nigeria	India	Nigeria	Bangladesh	Nigeria	Iran
55	Pakistan	Nigeria	Nigeria	Nigeria	Nigeria	Pakistan	Pakistan	Pakistan	Nigeria	India	Iraq

Note:
* Countries with Gross Domestic Product (GDP) exceeding USD 200 Billion have been included in the comparison. The countries have been arranged based on their performance on various indicators, with
** Taiwan, though a large economy, is not included for comparison in the table due to insufficient data.

Sources:
GDP Per Capita; Life Expectancy; IMR; OOPE; Employment in Agriculture
1. World Development Indicators, World Bank.
MMR
2. All Countries except Taiwan and Hongkong – UNICEF portal.
2. Hongkong – https://www.healthyhk.gov.hk/phisweb/en/chart_detail/17/
EYS; HDI; MYS
3. Human Development Index Report 2024, United Nations Development Programme
LFPR
5. World Bank portal
Power Consumption
6. Our World in Data portal.

Annexure 8: Details of Annual Transfers to Local Governments

Finance Commission	Year	Urban Local Governments (₹ crore)	Rural Local Governments (₹ crore)	Total grants to Local governments (₹ crore)	Devolution to States (₹ crore)	Share of Devolution (%)
12th	2005-2006	598	3,043	3,641	94,385	3.86
	2006-2007	1,000	3,398	4,398	1,20,330	3.65
	2007-2008	715	3,900	4,614	1,51,800	3.04
	2008-2009	1,221	4,177	5,399	1,60,179	3.37
	2009-2010	NA	NA	5,706	1,64,832	3.46
13th	2010-2011	2,062	5,781	7,843	2,19,303	3.58
	2011-2012	2,733	8,403	11,136	2,50,522	4.45
	2012-2013	4,050	10,217	14,267	2,91,547	4.89
	2013-2014	3,949	17,644	21,594	3,18,230	6.79
	2014-2015	6,188	16,211	22,399	3,37,808	6.63
14th	2015-2016	6,924	19,993	26,917	5,06,193	5.31
	2016-2017	14,498	31,370	45,868	6,08,000	7.54
	2017-2018	12,594	34,448	47,042	6,73,005	6.98
	2018-2019	14,400	35,064	49,464	7,61,454	6.49
	2019-2020	25,098	59,361	84,459	6,50,678	12.9
15th	2020-2021	26,710	60,750	87,460	5,94,997	14.7
	2021-2022	16,147	40,312	56,459	8,98,392	6.28
	2022-2023	17,779	45,578	63,357	9,48,407	6.66
	2023-2024(RE)	19,222	40,778	60,000	11,29,494	5.31
	2024-2025(BE)	25,653	49,800	75,453	12,47,211	6.04

The data in the Annexure has been used to compile Table 3.
RE: Revised Estimates; **BE:** Budget Estimates; NA: Not Available
Note:
1.Grants to Urban Local Governments for 2010-2011 to 2014-2015 have been calculated by subtracting Grants to Rural Local Governments from Total Grants to Local Governments.

Sources:
Devolution to States,Total Grants to Local Governments
1. FY 2005 - 2006 to FY 2024 - 2025, Union Budget of respective years.
Grants to Urban Local Governments
2. FY 2005 - 2006 to FY 2008-2009, Report of Thirteenth Finance Commission pg 442.
3. FY 2015 - 2016 to FY 2024-2025, Bugdet at Glance,Union Budget documents of respective years.
Grants to Rural Local Governments
4. FY 2005 - 2006 to FY 2008-2009, Report of Thirteenth Finance Commission pg 441.
5. FY 2010 - 2011 to FY 2014-2015, State-wise allocation and releases of 13th Finance Commission Grant for the award period (2010-2015), Ministry of Panchayati Raj.
6. FY 2015 - 2016 to FY 2024-2025, Budget at Glance, Union Budget documents of respective years.

Annexure 9: Urban Population Distribution according to City Size Class

Annexure 9: Urban Population Distribution according to City Size Class					
Year	Million Cities	Cities (100 thousand to 1 million)	Large Towns (50 to 100 thousand)	Medium Towns (20 to 50 thousand)	Small Towns (less than 20 thousand)
	% of Urban Population				
1971	26.02	31.22	10.92	16.01	15.83
1981	26.93	33.49	11.63	14.33	13.62
1991	33.18	32.02	10.95	13.19	10.66
2001	37.8	30.79	9.74	12.29	9.38
2011	42.89	23.25	9.33	12.78	11.75

The data in the Annexure has been used to generate Figure 4.

Source: *Urbanisation in India: Trend, pattern and policy issues (Working Paper No. 17). International Institute for Population Sciences.*

// Published by:
Foundation for Democratic Reforms (FDR)

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